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Statement of

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The Individual Alternative Minimum Tax

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Chairman Baucus, Ranking Member Grassley, Members of the Committee: Thank you for inviting me to share my views on the individual alternative minimum tax.

A precursor to the current individual alternative minimum tax (AMT) was originally enacted in 1969 to limit the amount of tax sheltering that taxpayers could pursue and to ensure that high-income filers paid at least a minimal amount of tax.[2] The current AMT, however, has strayed far from those original goals. Under current law, the tax will affect more than 23 million taxpayers in 2007, mainly for reasons that have nothing to do with tax sheltering. The AMT is expected to generate more than $800 billion in revenue over the next ten years under current law, a figure that rises to $1.5 trillion if the 2001–2006 tax cuts are extended. In short, the AMT threatens to grow from a footnote in the tax code to a major scourge affecting tens of millions of taxpayers every year.

As you well know, the practice in recent years has been to patch the AMT every year or two on a temporary basis so that not too many people are affected. The latest patch expired at the end of 2006. This stopgap approach leads to endless confusion. How much estimated tax should I pay?

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[1] My testimony draws heavily on joint work with my Tax Policy Center colleagues, Jeff Rohaly, Greg Leiserson, and Bill Gale. Views expressed are my own and should not be attributed to the Urban Institute, its trustees, or its funders.

[2] The original minimum tax was an addition to regular income tax. The current AMT is a floor on total tax liability. For details, see Joint Committee on Taxation (2007) or Burman, Gale, and Rohaly (2005).

What is my tax bracket? Would I benefit from the tax credit for hybrid vehicles if I bought one? More than 23 million people don't know the answer to these questions.

I applaud this committee for seeking a permanent solution to the AMT's problems and hope that you will do it in a fiscally responsible manner. Some influential members have claimed that, since the AMT would hit millions of people it was never intended to affect, we should never have counted on AMT revenue and its loss need not be offset. With all due respect, that argument would have been more persuasive in 2001 when surging AMT revenues helped make the case for the affordability of the ensuing tax cuts. Moreover, the AMT has masked much of the cost of the tax cuts since people on the AMT do not get the full benefit of income tax rate reductions. Eliminating the AMT after its existence has enabled the largest tax cuts in history without offsetting the lost revenue would amount to a major bait and switch.

Fortunately, fiscally responsible alternatives to the AMT exist. In my testimony, I describe several such options. My favorite option is a 4 percent surtax on adjusted gross income (AGI) over $200,000 for couples and $100,000 for others. The surtax would be more in keeping with the AMT's original purpose—making sure that high-income people paid at least some tax—and it would be simple and progressive. The vast majority of taxpayers subject to the AMT would pay lower taxes. What's more, since the AMT includes very high implicit tax rates—disincentives to work and save—the surtax alternative would actually represent a cut in effective tax rates for most people.

My testimony outlines how the AMT works, whom it affects, why it demands attention, and why financing AMT repeal or reform is important. I lay out a number of fiscally responsible options to fix or eliminate the AMT and discuss their effects on the distribution of tax burdens, the number of AMT taxpayers, and marginal tax rates.

How Does the AMT Work?

The individual AMT operates parallel to the regular income tax with a different income definition, rate structure, and allowable deductions, exemptions, and credits. In short, after calculating regular tax liability, taxpayers must calculate their "tentative AMT" under the alternative rules and rates and pay whichever amount is larger. To calculate tentative AMT, taxpayers must first determine their alternative minimum taxable income (AMTI) and then subtract the applicable AMT exemption amount (which is subject to phase-out), calculate tax under the AMT rate schedule, and subtract any applicable credits. Technically, AMT liability is the excess, if any, of tentative AMT above the amount of taxes due under the regular income tax alone.

Alternative minimum taxable income is the sum of three components: regular taxable income for AMT purposes, AMT preferences, and AMT adjustments. Regular taxable income for AMT purposes is basically the same as taxable income used for regular tax purposes, except it is allowed to be negative if deductions exceed gross income.

An AMT preference is an item identified as a potential tax saving in the regular income tax that is not permitted in the AMT. An AMT adjustment is simply any other exclusion, exemption, deduction, credit, or other treatment (such as a method for computing depreciation) in the regular income tax that is either restricted or disallowed in the AMT. Because there is generally no important economic distinction between preferences and adjustments, I will refer to both as preferences.

Interesting distinctions emerge among the various preferences themselves, however. Preferences are of two types: exemptions or deferrals. Exemption preferences broaden the AMT tax base and include the disallowance of personal exemptions, the standard deduction, and itemized deductions for miscellaneous expenses and state and local taxes. Deferral provisions change the timing of the recognition of income and deductions, typically to accelerate income and postpone deductions. Thus, they tend to raise the current-year tax base—and hence revenues—but only at the expense of future tax bases and tax collections.

Middle-income AMT taxpayers are primarily affected by the exemption preferences, which are added to taxable income. The exemption measures might be interpreted as an effort to reduce tax incentives generally and move toward an alternative tax base that is broader than the regular income tax base.

Deferral preferences outnumber exemption preferences, but they are used much less frequently, tend to be used by high-income taxpayers, and generate much less revenue. Deferral items tend to be complex; taxpayers generally need to recalculate income and costs using different schedules and keep separate books for regular tax and AMT purposes. Also, taxpayers may use AMT liability created by deferral provisions—but not by exemption provisions—as a credit against future years' regular tax liability in excess of the tentative AMT. The deferral provisions, coupled with the credit they create, are consistent with a policy goal of having every high-income filer pay some positive tax in each year, even if his or her overall multiyear tax liability does not change.

The Joint Committee on Taxation (2007) estimates that the three largest AMT preference items in 2006 were exemption preferences that few would consider to be aggressive tax shelters: deductions for state and local taxes (63 percent); personal exemptions, including exemptions for dependent children (22 percent); and miscellaneous itemized deductions, such as for unreimbursed business expenses (11 percent). As the AMT encroaches on more and more middle-income taxpayers, the share of the total accounted for by personal exemptions will rise to more than 40 percent as the share accounted for by the deduction for state and local taxes falls. The standard deduction will increase from 1 percent of the total in 2006 to 6 percent in 2007.

After adding back their preference items and determining alternative minimum taxable income, taxpayers may then subtract an AMT exemption amount of $45,000 for couples or $33,750 for singles and heads of household. That exemption is limited, however, for taxpayers filing joint returns with AMTI over $150,000 ($112,500 for singles and heads of household).[3] AMTI less any applicable exemption is taxed at two rates—26 percent on the first $175,000 and 28 percent on any excess above that amount. As under the regular income tax, capital gains and dividends

[3] The exemption is reduced by 25 percent of the amount that AMTI exceeds the relevant threshold. As a result, married couples filing joint returns can claim no exemption if their AMTI exceeds $330,000; single filers and heads of household get no exemption if their AMTI is greater than $247,500.

are subject to lower tax rates. If the resulting "tentative AMT" is greater than tax before credits calculated under the regular income tax, the difference is payable as AMT.[4]

That comparison means that anything that reduces the regular income tax relative to the AMT or that increases the tentative AMT relative to the regular income tax will move taxpayers onto the AMT. For example, a reduction in regular income tax rates not matched by a comparable change in the AMT would make more taxpayers subject to the AMT. The converse is also true: increasing regular income taxes or cutting AMT taxes would move some taxpayers off the AMT. If the 2001 and 2003 tax cuts are allowed to sunset after 2010 as scheduled, for example, fewer taxpayers will owe AMT, albeit only because their regular tax bills will have increased.

Congress has limited the AMT's reach in recent years by temporarily increasing the AMT exemption and allowing the use of personal nonrefundable credits against the AMT.[5] For the 2006 tax year, for example, Congress raised the exemption from $45,000 to $62,550 for couples and from $33,750 to $42,500 for single filers and heads of household. Those changes kept 16.5 million taxpayers from falling into the AMT's clutches. Because those adjustments were temporary, Congress will need to pass additional legislation to prevent a sharp rise in the number of taxpayers subject to the AMT, from about 4 million in 2006 to more than 23 million in 2007.

Box 1 shows the calculation of AMT for a married couple having four children and earning $75,000 in 2007. It illustrates how the AMT will ensnare even middle-class families with very straightforward tax returns if Congress does not act.

Whom Does the AMT Affect?

Under current law, the AMT affected about 4 million taxpayers in 2006.[6] With the expiration of the temporary AMT "patch" at the end of last year, the number of AMT taxpayers will increase dramatically in 2007 to 23 million, and continue to grow through 2010, eventually reaching 32 million, or more than a third of all taxpayers. With the expiration of most of the 2001–2006 tax cuts in 2011, the number of AMT taxpayers will fall to 18.5 million, before again marching steadily upward to hit 39.1 million by 2017. If the 2001–2006 tax cuts are extended, 52.6 million taxpayers—almost half of all taxpayers—will pay the AMT by 2017.

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[4] To be precise, the foreign tax credit is calculated before calculating the AMT and incorporated into the comparison between regular tax liability and AMT liability. Most credits, however, are calculated after both regular tax and AMT liability and do not affect the taxpayer's direct AMT liability.

[5] Other personal credits, such as the earned income tax credit, were allowed against the AMT by tax law changes included in the Economic Growth and Tax Relief Reconciliation Act of 2001 and will remain in place through 2010.

[6] Unless otherwise noted, estimates in this testimony are based on the Urban–Brookings Tax Policy Center's microsimulation model of the federal tax system. Taxpayers affected by the AMT include those with direct AMT liability, those whose credits are limited by the AMT, and those who choose to take itemized deductions that are lower than their standard deduction in order to reduce or eliminate their AMT liability. Our estimates differ slightly from those reported by the Joint Committee on Taxation (2007) because of differences in underlying data, assumptions about growth of income over time and other factors, and definitions of what it means to be affected by the AMT. (I present our estimates rather than the JCT's simply for purposes of internal consistency, since the JCT did not report all of the statistics I refer to in my testimony.) See Leiserson and Rohaly (2006) for further details on the Tax Policy Center's methodology.

Box 1. Calculating the AMT in 2007

A married couple with four children under age 17 has an income of $75,000 from salaries and interest on their savings account. Under the regular income tax, the family can deduct $20,400 in personal exemptions for themselves and their children. They can also claim a $10,700 standard deduction. For the regular tax, their taxable income of $43,900 places them in the 15 percent tax bracket, and they owe $5,803 in taxes before calculating the AMT or tax credits. A child tax credit of $4,000 ($1,000 per child) is allowed against both the AMT and the regular income tax. Their regular income tax after credits would be $1,803.

To calculate AMT liability, the couple adds preference items—personal exemptions of $20,400 and the standard deduction of $10,700—to taxable income and subtracts the married-couple exemption of $45,000, yielding $30,000 in income subject to AMT. That amount is taxed at the first AMT rate of 26 percent, for a tentative AMT liability of $7,800. The AMT equals the difference between the couple's tentative AMT and their regular income tax, or $1,997. Thus, the AMT more than doubles this couple's taxes—from $1,803 to $3,800

Two points about this example are worth noting. First, the family is on the AMT because they have four children, not because they are rich or aggressive tax shelterers: the family has no deferral preferences, no itemized deductions, no capital gains, and no other complicating factors. Second, the couple received no benefit from the new 10 percent rate bracket or higher standard deduction for couples enacted in 2001, because their income tax liability is set by the AMT, not the regular income tax.

AMT Calculation
Married couple filing jointly with four children, 2007

Calculate Regular Tax		**Calculate Tentative AMT**	
Gross income	$75,000	Taxable income	$43,900
Subtract deductions		*Add preference items*	
Personal exemptions	$20,400	Personal exemptions	$20,400
(6 x $3,400)		Standard deduction	$10,700
Standard deduction	$10,700	**AMTI**	**$75,000**
Taxable income	**$43,900**	*Subtract AMT exemption*	
Tax before credits	**$5,803**	AMT exemption	$45,000
Child tax credit	**$4,000**	**Taxable under AMT**	**$30,000**
		Tax (tentative AMT)	**$7,800**
Tax after credits	**$1,803**		
Tax bracket	15%	*AMT bracket*	26%

AMT = the excess of tentative AMT over regular income tax before credits
AMT = $7,800 - $5,803 = $1,997

Tax after AMT and Credits = $1,803 + $1,997 = 3,800

Although most AMT taxpayers are moderately well off, the tax is steadily encroaching on families that most would consider solidly middle-class. By 2010, half of all tax filers making between $75,000 and $100,000 will pay the AMT, up from 36 percent this year and less than 1 percent in 2006, when the temporary AMT fix was still in place (table 1).[7]

Although the AMT may have originally been intended to prevent high-income individuals from sheltering all of their income and paying no tax, it now affects more tax filers with moderately high incomes than it does at the very top of the income scale. Since the 35 percent top rate of the regular income tax exceeds the 28 percent top statutory rate of the AMT, individuals with very high incomes who do not shelter a substantial portion of it will end up in the regular tax system. In 2006, only 31 percent of filers with incomes above $1 million were affected by the AMT, compared with 51 percent of those with incomes between $200,000 and $500,000. By 2010, the difference is even starker: only 39 percent of millionaires will pay the AMT, but 94 percent of those in the $200,000 to $500,000 income class will.

What's more, many tax shelters exploit the difference in tax rates between long-term capital gains, which face a maximum tax rate of 15 percent, and ordinary income, which can be taxed at rates as high as 35 percent under the regular income tax. However, the lower capital gains tax rate is not considered an AMT preference item, so high-income taxpayers who report a large amount of capital gains receive the same tax break under the AMT as under the regular income tax. In contrast, before 1987, the tax break on capital gains was considered a preference item and was, in fact, the largest one.

In addition to being in certain income classes, taxpayers with any of several common situations are more likely than others to find themselves on the AMT:

Large Families. Personal exemptions are allowed against the regular income tax, but not the AMT. Taxpayers with large families have many personal exemptions, which significantly reduce their regular income tax liability relative to tentative AMT. In 2006, taxpayers with three or more children were almost four times as likely to owe AMT as those with no children (table 1). By 2010, almost half of families with three or more children will find themselves on the AMT, compared with only 17 percent of those without children.

High State and Local Taxes. State and local taxes are deductible under the regular income tax, but not the AMT. Thus, high state and local taxes reduce regular tax liability relative to AMT, increasing the likelihood that a taxpayer will owe AMT. This helps explain why, in 2004, taxpayers in the New York area, the District of Columbia, and California were most likely to owe AMT (Burman and Rosenberg 2006). They not only faced higher-than-average state and local tax burdens, but they also had higher-than-average incomes, making them substantially more likely than the average taxpayer to be subject to AMT. In 2006, households in high-tax states were almost three times more likely to be on the AMT than those in low-tax jurisdictions (table 1). With the dramatic growth of the AMT over the rest of this decade, however, this

[7] Tax filers include all nondependent tax units filing an income tax return, regardless of whether they owe income tax. Taxpayers include all nondependent tax units with positive income tax liability after credits. The Joint Committee on Taxation (2007) reports estimates for "taxpayers," which they define as all tax-filing units, including those that do not file tax returns and dependent returns.

Table 1
AMT Participation Rate (percent) by Individual Characteristics

	Current Law				Current Law Extended[a]	Pre-EGTRRA Law	
Group	**2006**	**2007**	**2010**	**2017**	**2017**	**2007**	**2010**
All Taxpayers[b]	4.0	25.9	33.6	34.7	48.6	10.6	16.0
All Tax Filers	2.8	18.4	24.5	27.8	37.4	8.0	12.4
Tax Filers by Cash Income (thousands of 2006$)[c]							
Less than 30	*	*	*	0.1	0.1	*	*
30-50	*	1.3	3.0	12.2	13.0	1.4	2.9
50-75	0.2	9.0	17.1	30.1	38.8	6.9	13.1
75-100	0.7	36.2	49.9	53.7	67.2	18.1	26.1
100-200	4.8	70.8	80.4	61.7	92.3	23.4	32.0
200-500	50.9	89.7	94.3	77.7	96.8	41.3	54.2
500-1,000	49.3	57.2	72.2	27.0	73.8	22.0	22.6
1,000 and more	31.4	33.8	38.8	20.3	40.1	20.3	19.1
Tax Filers by Number of Children[d]							
0	1.9	11.4	16.8	15.9	28.5	2.4	3.9
1	2.7	24.8	32.4	40.9	48.4	7.1	16.0
2	5.0	34.5	42.0	54.8	56.6	22.2	34.0
3 or more	7.4	39.6	48.4	65.3	64.4	39.8	50.3
Tax Filers By State Tax Level							
High	4.6	21.8	27.7	31.6	40.7	10.9	16.2
Middle	2.3	18.5	25.0	28.3	37.9	7.7	12.0
Low	1.6	15.3	21.1	23.8	33.9	5.7	9.2
Tax Filers by Filing Status							
Single	0.9	2.4	3.8	4.7	10.5	1.1	1.7
Married Filing Joint	5.1	36.7	47.9	49.7	67.2	14.5	22.2
Head of Household	1.3	10.4	17.0	33.1	35.0	8.3	14.5
Married Filing Separate	5.7	34.5	47.4	48.7	62.9	12.8	17.6
Married Couple, 2+ Kids, 75k<Cash Income<100k	0.2	59.1	73.6	92.3	92.8	57.5	74.3
Married Couple, 2+ Kids, 75k<AGI<100k	0.8	78.2	88.6	97.7	97.8	68.8	86.4

Source: Urban-Brookings Tax Policy Center Microsimulation Model (version 1006-1).
Notes:
Includes returns with AMT liability on Form 6251, with lost credits, and with reduced deductions. Tax units who are dependents of other tax units are excluded fom the analysis.
* Less than 0.05 percent.
(a) Includes all 2010 sunset provisions in current law.
(b) Taxpayers are defined as returns with positive income tax liability net of refundable credits.
(c) Tax units with negative cash income are excluded from the lowest income class. For a description of cash income, see http://www.taxpolicycenter.org/TaxModel/income.cfm.
(d) Number of children is defined as number of exemptions taken for children living at home.

differential is slated to fall dramatically. By 2010, residents of high-tax states will only be about 30 percent more likely to fall prey to the AMT than those in low-tax states (28 percent of households in high-tax states will face the AMT, compared with 21 percent in low-tax states.)

Marriage. Most married couples pay less tax under the regular income tax than they would if they were single. (That is, most “marriage penalties” have been eliminated and many couples receive “marriage bonuses.”) This is not true under the AMT. AMT tax rate thresholds are identical for married and single taxpayers and the AMT exemption is only 33 percent larger for couples than for singles (except for those for whom the exemption has been phased out). In contrast, the standard deduction for couples under the regular income tax is twice that for singles. The combination of the AMT marriage penalties, the fact that married couples often have children, and the fact that married couples tend to have higher household incomes resulted in married couples being more than five times as likely to owe AMT as singles in 2006. In 2007, with expiration of the temporary AMT fix, married couples are 15 times more likely to owe AMT than singles (table 1).

Taxpayer characteristics can combine to create very high probabilities of falling prey to the AMT. For example, absent a change in law, the AMT will become the *de facto* tax system for upper-middle-class families with children. In 2006, the AMT affected less than 1 percent of married couples with two or more children and adjusted gross income between $75,000 and $100,000, but by 2010 that share will rise to 89 percent (table 1).

Other common situations that make a taxpayer more likely to incur the AMT include having high medical expenses or simply taking the standard deduction. Taxpayers may deduct medical expenses in excess of 7.5 percent of AGI under the regular income tax, but the threshold is 10 percent of AGI under the AMT. Thus, taxpayers with both high incomes and high medical expenses can be hit hard by the AMT. Even claiming the standard deduction can force an individual into AMT territory. Although most AMT taxpayers itemize deductions, the standard deduction under the AMT is worthless for the few who claim it: it reduces regular tax liability without affecting tentative AMT.

Finally, current AMT rules allow for the possibility of very perverse outcomes. Under the regular tax, filers may deduct legal fees incurred in cases that generate taxable damages (such as punitive damages or damages for nonphysical injuries) as miscellaneous itemized deductions to the extent that they exceed 2 percent of adjusted gross income. However, the AMT disallows miscellaneous deductions. As a result, a taxpayer with substantial legal fees will have much less taxable income under the regular tax than under the AMT. If the legal fees are high relative to the damage award, the taxpayer can actually owe more AMT than her net gain from a lawsuit (Johnston 2003).

The exercise of incentive stock options generally creates income that is immediately taxable under the AMT but is not taxable under the regular income tax until the stock is actually sold. Individuals must include in AMTI the excess of the fair market value of the stock over the purchase price of the stock at the date of exercise (JCT 2006). This can cause taxpayers with very modest cash incomes to owe substantial AMT. If the stock is ultimately sold at a profit, the AMT paid earlier can be taken as a credit against the regular income tax owed. But if the stock price falls, the taxpayer can end up with a substantial AMT liability even though no income is ever realized.[8]

[8] The Tax Relief and Health Care Act of 2006 allows certain taxpayers to claim a refundable credit for 20 percent of their unused long-term alternative minimum tax credits (up to $5,000) per year. The refundable credit phases out for high-income taxpayers. The refundable AMT credits can generally only be claimed for tax years 2007–2012 (JCT 2006 and personal communication from Jerry Tempalski).

Why Is the AMT Becoming a "Mass Tax"?

Although the factors described above help explain why individual taxpayers are affected by the AMT, they do not explain the dramatic growth in the AMT. Two factors reduce regular income tax liabilities relative to tentative AMT over time and largely explain the explosive growth in AMT projected through 2010 and beyond.

Inflation. The AMT is not adjusted for inflation, whereas the regular income tax is. This means that if an individual's income just keeps pace with inflation each year, his or her regular income tax would remain constant (in real terms) while AMT liability would rise. The Joint Committee on Taxation (2007) estimates that the number of AMT taxpayers in 2010 would be reduced by about 88 percent (27 million) if the exemption had been indexed for inflation since 1987.[9]

The 2001–2006 Tax Cuts. The tax cuts reduced regular income tax liability, but made only temporary changes to the AMT. As a result, regular income tax declined relative to AMT liability, dramatically increasing the number of taxpayers subject to the AMT. In 2007, about 23 million taxpayers will be subject to the AMT under current law, more than double the 10.2 million that would have been affected had the tax cuts not been enacted.

Lindsey (2000) attributes much of the AMT growth to the AMT changes made in 1993. In fact, however, the 1993 changes, which raised rates in both the regular income tax and the AMT, but also increased the AMT exemption, served on net to reduce the number of AMT taxpayers. While 23.4 million taxpayers will face the AMT in 2007 under current law, if the AMT rates and exemption had remained at their pre-1993 levels, we estimate that 26.6 million taxpayers would face the AMT.

Should We Care about the Dramatic Growth of the AMT?

While many people decry the expanding reach of the AMT, others assert there is no cause for concern. Some argue that the complexity taxpayers face in calculating their taxes twice is not a reason to do away with the AMT, but rather cause to eliminate the regular tax. Others contend that the growing prevalence of tax preparation software negates any problems of complexity. In fact, both of those arguments have significant flaws.

[9] Real income growth also causes more taxpayers to become subject to the AMT over time because *effective* AMT tax rates are much higher than regular income tax rates for most taxpayers. (See Burman, Gale, and Rohaly 2005 for a discussion.) Thus, in most cases, the more income that is subject to AMT, the more likely it is that tentative AMT will exceed regular income tax. This is especially a problem for taxpayers in the phase-out range for the AMT exemption who are effectively taxed at rates 25 percent higher than the statutory AMT rate. The 26 percent rate becomes 32.5 percent; the 28 percent rate becomes 35 percent. This explains why almost all taxpayers with incomes between $200,000 and $500,000 are affected by the AMT (table 1). Real income growth is a minor factor in projected AMT growth compared to the lack of indexation and the impact of the tax cuts, however. Only 777,000 taxpayers would be subject to the AMT in 2011 if the AMT were indexed back to 1987 levels, according to the Joint Committee on Taxation. If the tax cuts are extended, about five times as many people would be affected, even with indexation.

Why not repeal the regular income tax?

Some people, observing the complexity of having two parallel methods of calculating taxes, argue that the best solution is to repeal the regular income tax. This option would have several advantages according to its proponents. They claim that the AMT is nearly a flat-rate tax with only two statutory rates, 26 and 28 percent, both of which are significantly lower than the top statutory rate of 35 percent under the regular income tax. In addition, the AMT applies those lower rates to a broader income base, since it eliminates various special tax breaks that exist in the regular tax system. They therefore conclude that it is a more efficient way of raising revenue than the regular tax system.

This analysis is incorrect for several reasons.[10] First, the AMT actually imposes four marginal tax rates, not two. The phase-out of the AMT exemption creates higher phantom tax rates of 32.5 and 35 percent, the latter equal to the top rate under the regular income tax (table 2).[11] And in fact, significantly more taxpayers face higher effective marginal tax rates under the AMT than they would under the regular income tax. In 2006, 71 percent of AMT taxpayers faced a higher marginal rate under the AMT; that figure will rise to 89 percent by 2010 as the AMT ensnares more and more middle-income filers who would have faced statutory rates of 15 or 25 percent under the regular income tax (Leiserson and Rohaly 2006).

Table 2. Effective Tax Rates on Ordinary Income and Capital Gains under the AMT, by Income, 2007

Income (AMTI) in Dollars		Tax Rate (Percent)	
Single	Joint	Ordinary Income	Capital Gains
33,750–112,499	45,000–149,999	26	15
112,500–189,499	150,000–205,999	32.5	21.5
190,000–247,499	206,000–329,999	35	22
247,500 and over	330,000 and over	28	15

Second, as described above, some of the base broadeners in the AMT have questionable validity as policy. In addition, the relatively high AMT exemption means that the AMT tax base is often smaller than the regular income tax base because the AMT exemption is larger than the total of all preference items for most taxpayers. In 2006, 63 percent of AMT taxpayers had more income subject to tax under the regular tax than they did under the AMT. That number will rise to 87 percent by 2010 (Leiserson and Rohaly 2006).

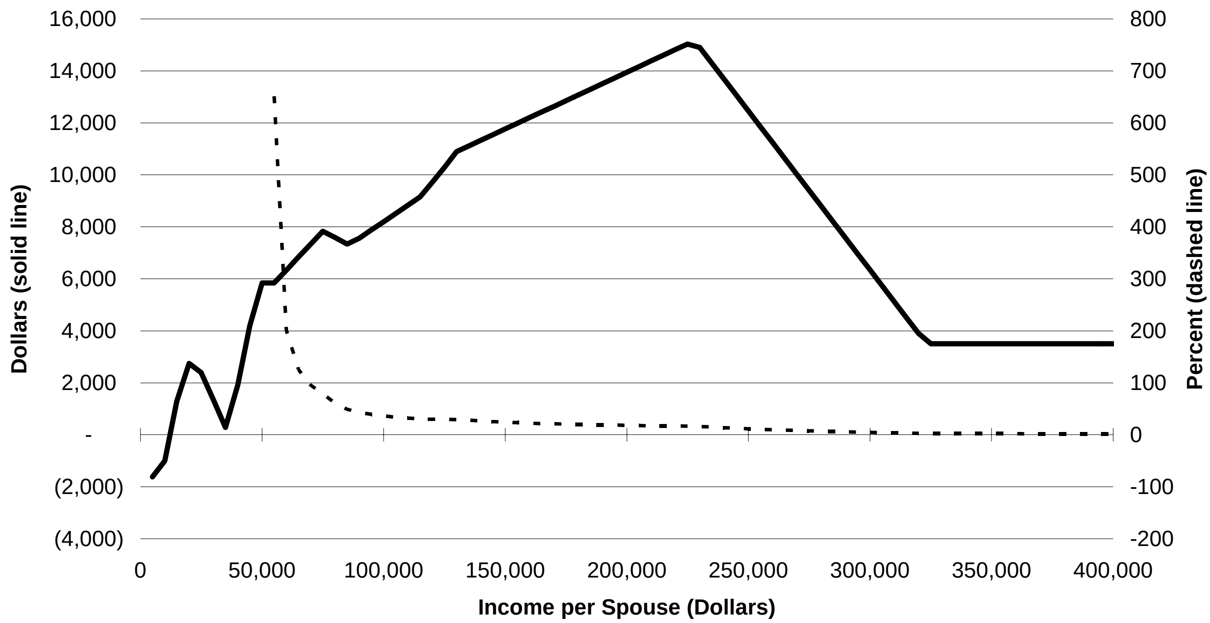
Thus, the conventional wisdom that the AMT applies a lower marginal tax rate to a broader income base and is therefore more efficient than the regular tax system is incorrect. In fact,

[10] For more detailed discussion, see Burman and Weiner (2005).
[11] Although the AMT generally preserves the lower statutory tax rates on capital gains and qualified dividends that exist under the regular tax system, the effect is diminished by the phase-out of the AMT exemption. Rather than the advertised 15 percent rate, taxpayers with incomes in the phase-out range can face effective marginal tax rates as high as 22 percent on gains and dividends. See Leiserson (2007) for details.

exactly the opposite is true. Most AMT taxpayers face a higher marginal rate applied to a more narrow tax base than they would if they were in the regular tax system.

As noted, the AMT also creates enormous marriage penalties. If the AMT were the only tax system, a married couple with two children earning $100,000 split equally between the two spouses would pay $5,837 more in taxes than they would if they were single and one spouse claimed custody of the children in 2006 (figure 1). At higher incomes, the marriage penalty would grow even larger, reaching a maximum of over $15,000 for couples with incomes of about $450,000 (although marriage penalties under current law are nearly as large at such high income levels).

Figure 1. Potential Marriage Penalties in AMT-only Tax System, 2006



Note: Chart assumes family of four with two children under age 17 (qualifying for child and earned income tax credit) in which each spouse has equal income. Itemized deductions allowed against AMT are assumed to be 12.6 percent of AGI. Marriage penalty calculated as the difference between the tax paid on a joint return and the sum of the tax paid on a head of household return with two children and a single return with no children.

Finally, if the AMT were the default tax system, the rightly reviled phenomenon of "bracket creep" would return with a vengeance. Since none of the AMT parameters are adjusted for inflation, people's tax bills would increase as a share of their income even if their income just kept pace with inflation—because more and more income would be above the exemption threshold (and for high-income taxpayers, more would be subject to the exemption phaseout and the 28 percent tax brackets).

Complexity

Policy analysts sometimes assert that the complexity of calculating taxes under both the regular tax and the AMT does not pose a real problem. Relatively few taxpayers prepare their own tax returns, they argue, and instead rely on tax preparation software, which calculates the AMT automatically, or paid tax preparers. It is true that the AMT is less complex for filers who use tax preparation software or a paid preparer, but at the cost of the income tax system's transparency. The fact that the tax system is a black box for so many people is something to regret, not champion.

In order to make informed decisions about work, saving, retirement, education, and other important matters, people should understand how the tax system affects those choices, but the AMT leads to endless confusion. Taxpayers will have a hard time predicting their marginal tax rate if they do not know whether they will be on the AMT. What's more, many people may be confused about what constitutes an AMT preference item. For example, *Consumer Reports* magazine reported in the February 2007 issue that the AMT is "snagging middle-income taxpayers with big families, people who pay lots of state tax, and those with high mortgage interest." Mortgage interest, of course, is not an AMT preference item (except on home equity lines and second mortgages used to pay for nonhousing expenses). And needless complexity contributes to public perceptions that the income tax system is unfair.

In any case, computer software has its limitations. For example, individuals who were on the AMT in the previous year must figure out the state tax deduction that would have been allowed on their prior-year tax return before they were subject to the AMT. This is necessary in order to figure out how much of their state tax refund in the current year is taxable. This calculation is so complex that my tax software doesn't do it. It recommends that I go back to my prior-year return, and keep refiguring my state tax deduction over and over until the AMT gets down to zero. This is complex even with software. Without it, the computation would be mind-numbing.

A second example involves the choice between itemizing and taking the standard deduction. Under the regular income tax, taxpayers claim the standard deduction as long as it exceeds the amount of itemized deductions. But taxpayers on the AMT should itemize even if their standard deduction is greater, as long as their non-preference itemized deductions exceed the portion of the standard deduction that makes their regular tax less than the AMT. Even though the AMT disallows the standard deduction, some taxpayers who do not owe much AMT (i.e., whose tentative AMT is not that much more than their tax under the regular system) get a partial benefit from the standard deduction. That is, they would not be on the AMT if they did not take the standard deduction. Does that sound complicated? It is. The last time I checked, my tax software did not deal with that issue either. Taxpayers should not have to figure this out for themselves.

A "blue state" tax?

Some partisans have suggested that the AMT is primarily the Democrats' problem because taxpayers in "blue states"—those who tend to vote for Democrats in national elections—are much more likely to owe AMT than those in "red states"—those who tend to vote Republican—to owe AMT. Although there has been an element of truth to this claim in the past, it is less relevant now. Absent a fix, the AMT will affect large numbers of taxpayers in all states starting this year. The tax especially affects middle- and upper-income families with children—the soccer moms and dads that both parties have courted in the past.

Even in 2004, when the AMT affected only about 2.5 percent of taxpayers nationwide, data from the IRS show that almost every state had hot spots with large percentages of taxpayers subject to the AMT (table 3). Almost half of states had at least one zip code with more than 20 percent of returns on the AMT. All but eight states had at least one zip code in which 10 percent or more returns were subject to the tax.

Revenue

Is there anything positive to say about the AMT? Over the long run, the AMT in its current form will become a more effective revenue generator than the regular income tax. The AMT will raise federal revenues by more than $800 billion over the next 10 years under current law and by $1.5 trillion if the 2001–2006 tax cuts are extended. Indeed, our estimates show that in 2007, it would cost less to eliminate the regular income tax than to eliminate the AMT. Over a longer time horizon, the Congressional Budget Office (2003) estimates that, primarily because of the AMT, federal taxes will claim 25 percent of GDP by 2050, compared with just under 19 percent today. That influx of revenue could help fund growing entitlement programs such as Social Security and Medicare as the baby boom generation retires.

But the AMT's power as a revenue generator stems entirely from the fact that its parameters are not indexed for inflation. In consequence, people whose incomes only just keep pace with inflation will face higher and higher average tax rates over time (a phenomenon sometimes referred to as bracket creep). And more and more people will find themselves in this situation as they become subject to the AMT over time.

Given this and all the other design flaws inherent in the AMT—marriage and family penalties, higher marginal tax rates likely to discourage working and saving and encourage inefficient tax avoidance behavior, and needless complexity—reforming or repealing the AMT in conjunction with reforming the regular income tax is far preferable to making the AMT the basis of our tax system.

Drawbacks of the Patch

I applaud the Chairman and Ranking Member for their commitment to finding a permanent solution to the AMT. The recent practice of temporarily increasing the exemption on a one- or two-year basis subjects taxpayers to tremendous uncertainty. They often do not know until late in the year whether they are going to be subject to the AMT and, if so, at what level. For example, in 2006, a patch was not enacted until May—after a substantial share of estimated tax payments and payroll withholding had been remitted for the year. Up until that point, taxpayers had to guess about whether they might owe as much as $4,000 or more in additional tax if the patch legislation did not pass. If they had guessed wrong, some could have been subject to penalties and interest for underpayment of estimated tax.

Taxpayers face even greater uncertainty this year, as Mr. Grassley implied in his floor statement on June 13 as the second quarter estimated tax payment deadline approached. In addition to the expiration of the patch, a provision that allows taxpayers to claim nonrefundable tax credits against the AMT also expired. Thus, taxpayers not only have to guess about their tax liability,

Table 3. AMT Hot Spots in Each State, 2004

State	Location	Zip Code	Percent on AMT	Statewide Percent on AMT	Average AMT (Dollars)	Average AGI (Dollars)
AK	Anchorage	99516	2	0.7	2,843	80,502
AL	Mountain Brook	35223	12	0.7	5,644	193,831
AR	Little Rock	72222	11	1.3	6,143	122,837
AZ	Paradise Valley	85253	14	1.1	10,196	352,910
CA	downtown LA	90071	34	4.0	10,901	378,733
CO	Castle Rock	80108	9	1.5	3,705	138,780
CT	Weston	06883	28	4.8	4,965	289,891
DC	Washington	20015	19	1.6	4,109	162,845
DE	Wilmington	19890	32	4.2	15,571	280,474
FL	Boca Grande	33921	28	1.5	13,569	487,888
GA	Sea Island	31561	41	1.9	11,787	592,116
HI	Honolulu	96802	10	1.6	7,615	150,852
IA	Urbandale	50323	11	1.4	2,793	117,852
ID	Sun Valley	83353	10	1.9	8,134	124,317
IL	Peoria	61629	28	1.0	4,795	187,727
IN	Indianapolis	46285	22	1.3	4,582	221,153
KS	Overland Park	66224	18	1.6	3,301	160,686
KY	Glenview	40025	29	1.4	5,091	228,400
LA	around Tulane	70161	45	1.0	5,947	199,619
MA	Weston	02193	35	1.9	9,117	702,161
MD	Potomac	20854	23	3.9	5,925	230,205
ME	Cumberland County	04110	23	3.8	6,899	202,318
MI	Southfield	48086	31	1.5	1,420	241,130
MN	St. Paul	55144	41	2.4	6,088	282,581
MO	Saint Albans	63073	22	0.7	5,041	318,127
MS	Jackson	39205	7	1.3	5,650	112,828
MT	Sweet Grass	59484	15	1.4	200	21,742
NC	Charlotte	28207	22	1.6	6,609	245,834
ND	Milnor	58060	7	1.2	577	34,205
NE	Lincoln	68520	12	1.7	5,108	139,401
NH	Rye Beach	03871	13	5.5	5,114	251,862
NJ	Mountain Lakes	07046	32	1.1	5,720	259,019
NM	Albuquerque	87122	8	5.1	3,339	105,104
NV	Henderson	89011	19	1.8	12,073	889,783
NY	Park Ave.	10172	65	0.8	2,790	293,196
OH	Cincinatti	45201	25	2.2	3,425	140,391
OK	Oklahoma City	73151	11	1.1	2,490	133,344
OR	Beaverton	97076	34	2.3	2,176	191,760
PA	Delaware County	19085	22	2.0	7,097	346,724
RI	East Greenwich	02818	13	2.7	4,132	109,471
SC	Greenville	29603	20	1.4	4,929	144,479
SD	North Sioux City	57049	3	0.6	5,904	140,220
TN	Memphis	38130	10	0.7	8,424	106,169
TX	Houston	77210	30	1.3	4,972	214,026
UT	Salt Lake City	84150	14	1.4	2,867	103,827
VA	Clifton	22024	29	1.9	2,813	215,582
VT	Norwich	05055	13	2.6	4,331	85,503
WA	Medina	98039	16	1.2	9,090	561,909
WI	Elm Grove	53122	16	0.8	4,704	146,717
WV	Charleston	25314	6	2.0	3,897	82,566
WY	Wilson	83014	8	0.9	10,327	287,880

Source: Tax Policy Center analysis of ZIP Code tables provided by the Statistics of Income Division of the Internal Revenue Service.

but they also have to wonder whether they will get any benefit from education credits, the child and dependent care tax credit, and the tax credit for fuel efficient vehicles, to name just a few. This uncertainty undermines the effectiveness of these tax incentives.

The political appeal of temporary fixes for the AMT is obvious—it is a lot easier to pay for a $50 billion temporary patch than for a permanent fix that could reduce tax revenues by hundreds of billions of dollars. But the retroactive nature of the patches amounts to playing a game of "chicken" with the American taxpayer, who should not have to guess.

Financing AMT Reform or Repeal

Reforming or repealing the AMT is costly and financing that cost is important. Outright repeal of the AMT, without any other offsetting changes, would reduce tax revenues by more than $800 billion through fiscal year 2017, *assuming that the 2001–2006 tax cuts expire after 2010*. If the tax cuts are extended, the 11-year revenue loss nearly doubles to almost $1.6 trillion.

Some have pointed out that the AMT would tax people who were never its intended target and thus AMT revenues should never have been counted on. The real baseline, they assert, should assume no AMT. But that argument had at least as much salience in 2001, when AMT revenues were counted on to mask the true cost of proposed tax cuts. What's more, if the baseline should exclude the AMT, then projections should have recognized that the nation's fiscal position was worse than advertised.

In 2001, legislators understood that the AMT would "take back" a significant portion of the tax cuts and therefore keep their estimated cost within the tax bill's $1.35 trillion target.[12] By 2010, the AMT will reclaim almost 28 percent of the individual income tax cuts, including more than 70 percent of the cut that would have gone to taxpayers making between $200,000 and $500,000 (Leiserson and Rohaly 2006).

Repeal of the AMT would be not only prohibitively expensive but also extremely regressive. Nearly 96 percent of the tax cut arising from AMT repeal in 2007 would go to the top fifth of income earners and 80 percent would go to the top tenth. More than half would go to taxpayers with incomes greater than $200,000. After-tax incomes of taxpayers with incomes between $200,000 and $500,000 would rise by 2.7 percent, or an average of nearly $6,000. In contrast, taxpayers in the middle quintile of the income distribution would receive less than 1 percent of the benefits and would see their after-tax income rise by an average of only $5.

[12] House Ways and Means Committee Democratic staffer, Al Davis (2000), pointed out the interaction of the president's proposals with the AMT a year before the legislation was considered by Congress. Larry Lindsey (2000), who advised the Bush campaign and later became a top economic adviser to the president, said that the failure to reform or eliminate the AMT was a matter of priorities given budget constraints: "Should additional revenue become available, reductions in the AMT might well be desirable." The logical corollary to that statement given the dramatic deterioration of budget projections since 2000—when large surpluses were anticipated—is that AMT reform should only occur in a fiscally responsible way.

Revenue-Neutral Options to Repeal or Reform the AMT

Repeal Options

There are numerous options to finance repeal of the AMT. The best one would be to do it in the context of broad-based tax reform that could finance the revenue loss with the elimination of loopholes, deductions, and credits while keeping income tax rates low. President Bush's advisory panel on federal income tax reform proposed one such plan, but the deafening silence with which that panel's report was met suggests that the nation may not yet be ready for a major tax overhaul.

There are many stand-alone options to finance AMT repeal that would be significant improvements over current law. Four are outlined below: (1) imposing a 4 percent of AGI surtax above $200,000 for couples ($100,000 for singles); (2) repealing the state and local tax deduction and *reducing* income tax rates by 2 percent, (3) increasing regular income tax rates in the 25 percent and higher brackets by 15 percent, and (4) increasing regular income tax rates in the 25 percent and higher brackets by 12 percent and repealing the 2003 tax cuts for capital gains and qualified dividends.

One attractive option would be to combine AMT repeal with a 4 percent tax on AGI in excess of $200,000 for married couples or $100,000 for other tax filers.[13] This would sharply reduce the number of high-income tax filers who pay no federal income tax. It would be approximately revenue-neutral over the 2007–2017 budget window. Through 2010, even with the 4 percent add-on tax, the top effective tax rates on ordinary income and capital gains would remain below the pre-EGTRRA levels of 39.6 and 20 percent.

Some commentators have complained that the surtax would be counterproductive because it would raise marginal tax rates and spur tax avoidance.[14] However, the modest surtax would replace the high marginal tax rates that already exist under the AMT. In 2007, about three times as many people would face a cut in marginal tax rates on ordinary income as would face higher rates under the option (table 4). The vast majority of affected taxpayers with incomes under $200,000 and more than a third of those affected with incomes between $200,000 and $500,000 would face lower effective rates. About 90 percent of tax units would see no change in their effective capital gains tax rates. For those with a change, the majority would pay higher rates, but a significant number of taxpayers would see a cut because of the elimination of the AMT exemption phaseout. The bottom line is that, unlike a rate increase alone, which would reduce incentives to work and save, the proposal improves work incentives for most taxpayers and is a mixed bag in terms of saving.

[13] See Burman and Leiserson (2007) for more discussion of this option.
[14] See, e.g., Viard (2007).

Table 4. Distribution of Tax Units by Change in Marginal Tax Rate for Four Options to Repeal the AMT, 2007

Cash Income Class (thousands of 2006 dollars)[a]	Change in Marginal Tax Rate On Wages: Percent with Increase	Change in Marginal Tax Rate On Wages: Percent with Decrease	Change in Marginal Tax Rate On Wages: Percent with No Change	Change in Marginal Tax Rate On Capital Gains: Percent with Increase	Change in Marginal Tax Rate On Capital Gains: Percent with Decrease	Change in Marginal Tax Rate On Capital Gains: Percent with No Change
Repeal AMT						
Less than 100	0.1	5.5	94.4	1.0	1.1	97.9
100-200	4.6	63.0	32.4	20.7	18.5	60.8
200-500	20.7	68.4	10.8	18.5	58.2	23.3
500-1,000	38.9	17.1	44.0	32.9	9.7	57.3
More than 1,000	20.5	12.0	67.5	20.1	4.3	75.7
All	1.4	13.9	84.7	3.9	4.8	91.3
Repeal AMT & Implement 4% Surtax on AGI Above 100/200K						
Less than 100	0.1	5.5	94.4	0.9	1.1	98.0
100-200	15.2	59.8	25.0	25.6	16.2	58.2
200-500	59.6	34.6	5.8	27.8	48.7	23.5
500-1,000	83.9	11.0	5.1	65.3	4.7	30.0
More than 1,000	90.8	7.9	1.4	69.5	2.6	27.9
All	4.2	12.5	83.3	5.0	4.2	90.8
Repeal AMT, Repeal State and Local Tax Deduction & Reduce Tax Rates by 2%[b]						
Less than 100	2.5	60.2	37.3	2.8	10.8	86.4
100-200	10.6	88.4	1.0	20.6	23.1	56.3
200-500	24.3	74.0	1.8	11.8	63.0	25.1
500-1,000	41.2	57.0	1.8	26.7	31.8	41.4
More than 1,000	22.1	75.3	2.7	13.4	41.1	45.6
All	4.3	63.5	32.2	5.2	13.9	80.9
Repeal AMT & Increase Top Three Tax Rates by 15%						
Less than 100	0.2	5.5	94.3	0.9	1.1	98.0
100-200	17.0	58.1	24.8	19.7	16.4	63.8
200-500	68.1	24.6	7.3	19.9	54.2	25.9
500-1,000	79.9	13.7	6.5	58.2	5.9	35.9
More than 1,000	85.8	10.4	3.8	56.6	3.4	39.9
All	4.7	12.0	83.3	4.0	4.4	91.6
Repeal AMT, Roll Back Capital Gains Rates, & Increase Top Three Tax Rates by 12%						
Less than 100	1.4	5.6	93.0	60.0	0.4	39.6
100-200	16.0	61.6	22.4	81.2	9.5	9.2
200-500	50.6	44.7	4.7	35.9	46.8	17.3
500-1,000	82.3	12.4	5.3	70.7	4.2	25.0
More than 1,000	89.6	8.6	1.8	70.5	2.6	26.9
All	5.1	13.0	81.8	61.5	2.9	35.7

Source: Urban-Brookings Tax Policy Center Microsimulation Model (version 1006-1).
Notes:
Calendar year. Baseline is current law.
(a) Tax units with negative cash income are excluded from the lowest income class but are included in the totals. For a description of cash income, see http://www.taxpolicycenter.org/TaxModel/income.cfm
(b) The estimates in this table show marginal rates for federal taxes holding constant state taxes paid. A more complete consideration of marginal rates without this limitation would show somewhat different results.

This option is highly progressive. Taxpayers in the 60th through 99th percentiles would, on average, receive a tax cut from the proposal through 2010 (table 5). The proposal also has the advantage of returning the AMT to its original purpose—guaranteeing that high-income people pay at least some tax. Like the original minimum tax, the surtax is an addition to regular tax rather than an alternative tax system. It would be extremely simple to calculate. And it would significantly reduce the number of taxpayers who can avoid income tax altogether (although those with income only from public-purpose tax-exempt bonds could continue to avoid tax).

Table 5. Distributional Impact of AMT Reform Options, 2007 and 2010

Reform Option	Percent Change in After-Tax Income by Cash Income Percentiles[a]											
	2007						2010					
	40-60	60-80	80-90	90-95	95-99	99-100	40-60	60-80	80-90	90-95	95-99	99-100
Repeal the AMT	0.0	0.2	0.9	1.4	2.6	1.1	0.0	0.4	1.5	2.1	3.6	1.4
With financing												
Repeal, implement 4% of AGI add-on tax above 100K/200K	0.0	0.2	0.9	1.3	1.6	-2.8	0.0	0.4	1.4	1.8	2.5	-2.4
Repeal, repeal state and local tax deduction, reduce regular tax rates by 2%[b]	0.0	-0.1	0.2	0.3	1.0	-0.5	0.0	0.2	0.8	1.0	2.1	-0.3
Repeal, increase top three regular tax rates by 15%	0.0	0.2	0.9	1.3	1.4	-2.0	0.0	0.4	1.4	1.9	2.4	-1.7
Repeal, roll back rates on capital gains and qualifying dividends, increase top three regular tax rates by 12%	0.0	0.1	0.7	1.1	1.1	-3.4	0.0	0.4	1.4	1.8	1.6	-3.7
Extend and index 2006 law	0.0	0.2	0.9	1.3	1.8	0.1	0.0	0.4	1.4	2.0	2.5	0.1
With financing												
Increase top three regular tax rates by 12%	0.0	0.2	0.8	1.2	1.2	-2.1	0.0	0.4	1.4	1.8	2.0	-1.9
Increase AMT rates by 21%	0.0	0.2	0.8	0.8	-1.2	-2.4	0.0	0.4	1.3	1.2	-0.9	-2.8
Disallow pref. rates on capital gains and qualifying dividends, increase top three regular tax rates by 3%	0.0	0.2	0.9	1.2	0.9	-4.1	0.0	0.4	1.4	1.8	1.6	-3.7
Broad reform: extend and index 2006 law; allow dependent exemptions; allow standard and itemized deductions[c]	0.0	0.2	0.9	1.4	2.4	0.7	0.0	0.4	1.5	2.1	3.5	1.0
With financing												
Increase top three regular tax rates by 14%	0.0	0.2	0.9	1.3	1.4	-2.1	0.0	0.4	1.4	1.9	2.3	-1.8
Disallow preferential rates on capital gains and qualifying dividends, increase top three regular tax rates by 7%	0.0	0.2	0.9	1.3	1.4	-4.0	0.0	0.4	1.4	1.9	2.4	-3.4

Source: Urban-Brookings Tax Policy Center Microsimulation Model (version 1006-1).
Notes:
Calendar years. Baseline is current law. Plans take effect 1/1/07. Includes both filing and non-filing units but excludes those that are dependents of other tax units.
(a) After-tax income is cash income less: individual income tax net of refundable credits; corporate income tax; payroll taxes; and estate tax. For a description of cash income, see http://www.taxpolicycenter.org/TaxModel/income.cfm.
(b) Increases and decreases in tax rates are applied to rates before and after the sunset of the 2001-2006 tax cuts separately.
(c) Includes state and local tax, miscellaneous, and medical deductions.

Instead of increasing effective tax rates, repeal could be financed by base broadening under the regular income tax. The president's tax reform panel proposed to eliminate the income tax deduction for state and local taxes (among many other measures) as a way to finance AMT repeal. The tax deduction is an inefficient instrument to help states—primarily benefiting states with high average incomes (since lower-income people usually do not itemize and, even when they do, the deduction is worth little to them because they are in low tax brackets).[15] Moreover, since the tax deduction is an AMT preference, over time, fewer and fewer taxpayers would be able to gain its full benefits under current law.

Assuming that the 2001–2006 tax cuts expire as scheduled at the end of 2010, repealing the state and local tax deduction would raise more than enough revenue to finance AMT repeal, allowing for a 2 percent reduction in income tax rates. The net effect of AMT repeal, state and local tax deduction repeal, and income tax rate reduction has very small effects on overall tax burdens by income group. This occurs because, although AMT repeal is regressive, repeal of the state and local income tax would be quite progressive. Most taxpayers in the bottom 60 percent of the income distribution take the standard deduction, so that the primary beneficiaries of the state and local tax deduction are those at the very top of the income scale who escape the AMT.

This option has significant effects on marginal tax rates. Almost 64 percent of households would face lower marginal rates on ordinary income, while almost 14 percent would pay lower rates on capital gains (table 4). The tax cut on wage income arises primarily because of the modest reduction in rates, and is generally small, but also because of eliminating the AMT. The tax cuts on capital gains also arise from AMT repeal and because the lower income tax rate means that the phaseout of itemized deductions creates a slightly (2 percent) smaller effective tax surcharge than it does under current law.[16] Interestingly, more people face marginal rate increases under this option than under repeal. This occurs because repeal of the deduction pushes some taxpayers with modest incomes into higher income tax brackets.

Since repealing the AMT primarily benefits higher-income taxpayers, it makes sense to offset the revenue losses by increasing top income tax rates. To finance repeal, statutory rates of 25 percent and above could be increased by 15 percent, resulting in top rates of 32.3, 38.0, and 40.3 percent through 2010 (from 28, 33, and 35 percent) and 35.7, 41.5, and 45.6 percent in 2011 and thereafter (from 31, 36, and 39.6 percent). Through 2010, only the top 1 percent of households would face an average tax increase, amounting to about 2 percent of after-tax income. This occurs because very high income earners are most affected by the rate increases and do not tend to benefit as much from repeal of the AMT since they tend not to be on the AMT in the first place. Through 2010, those in the 90th to 99th percentiles receive the largest average tax cuts

[15] See Rueben (2005) for a general discussion, or Burman and Gale (2005) in the context of the proposal made by the President's Advisory Panel on Tax Reform (2005).

[16] Under current law, itemized deductions phase out at a 2 percent rate for taxpayers with incomes above certain thresholds ($156,400 for most taxpayers in 2007). Like the phaseout of the AMT exemption, the deduction phaseout implicitly creates a surtax, which in this case equals 2 percent of the statutory tax bracket. The surtax applies to capital gains as well as ordinary income. Thus, an increase in ordinary income tax rates increases the effective tax rate on capital gains and dividends for taxpayers affected by the phaseout. (Note that due to tax law changes in EGTRRA this provision is being phased out, but it will return at its original 3 percent rate in 2011 if the tax cuts are not extended.)

under this plan, between 1.3 and 1.4 percent of after-tax incomes in 2007, and between 1.9 and 2.4 percent in 2010.

Finally, AMT repeal could be an opportunity to rein in tax shelters in the regular income tax. For example, rolling back the 2003 tax cuts on dividends and capital gains would reduce the incentive to convert ordinary income into these tax-preferred forms. It would also raise some revenue to allow for a smaller increase in ordinary income tax rates. The top three income tax rates would increase by 12 percent under this option. The option would cut taxes by a modest amount for middle- and upper-middle-income taxpayers and increase taxes significantly for high-income taxpayers, especially through 2010, when current law allows for lower rates on capital gains and dividends. Taxpayers in the top 1 percent of the income distribution would, on average, pay additional taxes equal to 3.4 percent of after-tax income in 2007. These households lose out for three reasons—they are most affected by the income tax rate increases, they have a large amount of capital gains and dividends, and many taxpayers in this group do not owe AMT (and thus receive no benefit from repeal).

Reforming the AMT to Spare the Middle Class

Rather than outright repeal, the AMT could be reformed in order to shield middle- and upper-middle-income taxpayers from its effects.[17] The simplest reform would be to extend the exemption increase in place for 2006 and index the AMT for inflation. This would prevent inflation from increasing tentative AMT (in real terms) and conform the AMT treatment with that under the regular income tax.[18] If indexation were applied to rate brackets and the phase-out as well as the exemption, only 3.6 million taxpayers would be subject to the AMT in 2007, down from 23.4 million under current law (table 6). The number of AMT taxpayers with incomes less than $100,000 would fall by more than 98 percent. By 2010, real income growth would increase the number of AMT taxpayers to 4.6 million, still significantly lower than the projected 32.4 million under current law.

A more comprehensive reform would also allow dependent exemptions, state and local tax deductions, the deductions for miscellaneous expenses and medical expenses, and the standard deduction for AMT purposes. This would reduce the number of AMT taxpayers to fewer than 500,000 in 2007 and would spare virtually all taxpayers with incomes below $200,000 from the AMT.

These reforms would, however, substantially reduce federal tax revenues. We estimate that indexing the AMT for inflation from 2006 levels would reduce revenues by about $0.6 trillion from 2007 to 2017, assuming the 2001–2006 tax cuts expire as scheduled. The comprehensive reform package would reduce revenues by $0.8 trillion if the tax cuts expire.

[17] For more information on these options, and others, see Burman et al. (2007).
[18] The AMT exemption was increased between 2005 and 2006 as an ad hoc inflation adjustment, but it has never been formally indexed for inflation. The allowance of personal nonrefundable credits against both the regular tax and the AMT would also be extended under all reform options considered here.

Table 6. Effect of AMT Reform Options on Number of AMT Taxpayers (millions) by Cash Income Class, 2007

	Cash Income Class ($ thousands)				
Reform Option	**All**	**0-100**	**100-200**	**200-1,000**	**More than 1,000**
Extend and index 2006 law	3.6	0.1	0.1	2.6	0.1
With financing					
Increase top three regular tax rates by 12%[a]	2.4	0.1	0.7	1.5	0.1
Increase AMT rates by 21%	9.6	0.4	4.2	4.5	0.4
Disallow preferential rates on capital gains and qualifying dividends in the AMT, increase top three regular tax rates by 3%	4.4	0.2	1.3	2.8	0.2
Broad reform: extend and index 2006 law; allow dependent exemptions; allow standard and itemized deductions[b]	0.4	0.0	0.0	0.3	0.1
With financing					
Increase top three regular tax rates by 14%	0.3	0.0	0.0	0.2	0.0
Disallow preferential rates on capital gains and qualifying dividends in the AMT, increase top three regular tax rates by 7%	1.2	0.0	0.3	0.8	0.1
Addendum: Current law baseline	23.4	7.0	11.8	4.4	0.1

Source: Urban-Brookings Tax Policy Center Microsimulation Model (version 1006-1).

Notes:

Calendar years. Baseline is current law. Plans take effect 1/1/07. Excludes dependent returns. AMT taxpayers are defined as those with an AMT liability from form 6251, with lost credits, or with reduced deductions.

(a) Increases in tax rates are applied to rates before and after the sunset of the 2001-2006 tax cuts separately.

(b) Includes state and local tax, miscellaneous, and medical deductions.

Offsetting the Revenue Cost of the Middle-Class Reforms

The revenue cost of the reforms outlined above could be offset in a variety of ways. All the offset options described below are intended to be roughly revenue neutral over the 2007–2017 budget window, and assume that the 2001–2006 tax cuts expire as scheduled. If the tax cuts are extended, each of the options would generally lose substantial amounts of revenue over the budget window, and many more people would be subject to the AMT after 2010.

Although there are myriad ways in which the revenue cost of the reforms could be financed, I will discuss three illustrative options: (a) increasing the top three income tax rates under the regular tax; (b) increasing the AMT rates; or (c) combining (a) with disallowing the preferential rates on capital gains and dividends under the AMT.

Financing the reforms by increasing AMT rates rather than by raising regular income tax rates leaves more individuals subject to the AMT, particularly those with incomes over $200,000. Since both of the reforms mentioned above involve substantial increases in the AMT exemption, they tend to shield those with incomes under $100,000 from the AMT. In addition, raising regular income tax rates and thus regular income tax liability reduces the number of people for whom tentative AMT is greater than regular tax and thus further reduces the number of AMT taxpayers. In contrast, raising AMT rates tends to increase the number of people for whom tentative AMT is greater than regular tax.

Eliminating the preferential rates for capital gains and dividends under the AMT allows smaller increases in either regular or AMT tax rates. These options also tend to retarget the AMT toward those with very high incomes—since those taxpayers tend to have a higher share of their income in the form of capital gains—which is more consistent with the AMT's original intent. Moreover, since many tax shelters exploit the lower tax rate on capital gains, eliminating preferential gains rates would likely do more to stem tax sheltering than any of the existing AMT preferences.[19]

Extending the exemption and indexing the AMT for inflation would require a 12 percent increase in the top three regular income tax rates. (We raise only the top rates because the AMT primarily affects taxpayers in the upper brackets.) Under this option, the top rate would increase from 35 to 39.1 percent through 2010 and from 39.6 to 44.3 percent for 2011 and thereafter. The number of AMT taxpayers would fall to 2.4 million in 2007; only 100,000 of them would have incomes below $100,000. The change in tax burdens by income quintiles would be small, never more than 1 percent of income. The highest-income taxpayers, however, would pay more tax. By 2011, the top 1 percent pays additional tax equal to about 3 percent of income.

If AMT rates were raised instead, to 31.3 and 33.8 percent, the AMT would affect 9.6 million taxpayers in 2007; the number of AMT taxpayers with incomes of $200,000 and

[19] See Burman (1997) for a discussion of the connection between capital gains tax preferences and tax shelters.

over would actually rise relative to current law. AMT liabilities would also increase for higher-income households, and so they would pay higher taxes on average. Households in the 95th to 99th percentiles would experience a tax increase of about 1 percent of income through 2010, and those in the top 1 percent would pay additional taxes equal to almost 3 percent of income. After 2010, the tax increases are much smaller because the higher AMT exemption in combination with the pre-EGTRRA regular income tax rates results in fewer upper-income households owing AMT.

If the preferential rates on capital gains and dividends were disallowed for AMT purposes, the required increase in the top three regular income tax rates would be only 3 percent. The top rate, for example, would need to rise from 35 to 36 percent through 2010 and from 39.6 to 40.7 percent thereafter. This option would reduce the number of AMT taxpayers by more than 80 percent in 2007, to 4.4 million. The AMT would be much more targeted at those with high incomes; taxpayers with incomes greater than $1 million would be more likely to owe AMT under this option than under current law. The tax change is significant for those at the very top, however. The top 1 percent would see an average tax increase of about 4 percent of after-tax income in 2007, although the size of that tax increase would decline over time.

Since broad reform of the AMT costs substantially more, financing it would require larger increases in either regular or AMT rates. The required increase in the top three regular rates would be 14 percent, resulting in a top rate of 39.9 percent through 2010 and 45.2 percent thereafter. This option reduces the number of AMT taxpayers to only 300,00 in 2007, including less than 100,000 with incomes less than $200,000. Since this option reduces tax revenues in the first five years and increases it thereafter, the largest tax increases occur after 2010. The average tax increase is about 3 percent of income for those in the top 1 percent after 2010.

Finally, broad reform could be financed by disallowing the preferential rates on capital gains and dividends under the AMT combined with an increase in the top three regular income tax rates. The required rate increase would be 7 percent, resulting in a top rate of 37.5 percent through 2010 and 42.4 percent thereafter. This option would reduce the number of AMT taxpayers by about 95 percent in 2007, to just 1.2 million, with only 300,000 of them having incomes less than $200,000. This option would have very small effects on the distribution of tax burdens by quintile. But disallowing the lower capital gains rates under the AMT, combined with the regular tax rate increases, results in significant tax increases for those at the very top of the income scale—over 3 percent of income for those in the top one percent before 2010.

Conclusions

Lack of inflation indexing in the alternative minimum tax expands the reach of the tax each year. The 2001–2006 tax cuts have further exacerbated the problem by reducing regular income tax liabilities without corresponding permanent changes to the AMT. Caught amid these trends, one in three American taxpayers will soon face a tax that almost none of them were meant to pay. Although the goals of the AMT—ensuring high-income taxpayers pay at least some amount of tax each year and reducing inefficient tax sheltering—may command public support, the AMT is a highly imperfect way of achieving those goals. In particular, under current law, the AMT will come to plague the middle- and upper-middle-income classes with undue complexity, a narrower tax base, and higher marginal tax rates than under the regular income tax.

As the AMT expands, the political benefits of achieving a solution increase as well. A number of sensible reform options are available. A significant barrier to AMT reform is the challenge of what to do about the lost revenues. Official budget estimates assume that the AMT will provide tax revenues of nearly $1 trillion over the next 10 years. Even modest reforms, such as extending the AMT "patch" and indexing the AMT for inflation, would reduce tax revenues over that period by more than $500 billion. Given our fiscal situation, making up that lost revenue would seem to be a necessary precondition for reform.

I have illustrated a number of options for repealing or reforming the AMT without increasing the deficit over the 10-year budget period. The options show that it would be feasible to repeal or sharply scale back the AMT in a fiscally responsible manner with relatively minor dislocations. All of the options produce winners and losers—it would be impossible to design a sensible revenue-neutral alternative to the AMT that didn't—but many would cut taxes modestly on the middle class and have relatively small effects on those with higher incomes.

Many other fiscally responsible options exist, and some of them might be better politics or policy than the ones I discussed. For example, this Committee has explored options to improve tax compliance and collections as a way to raise revenue. To the extent that more of the tax that is due to the IRS could be collected, the revenue needs to finance AMT reform would be reduced. As a result, the options here could be implemented with smaller income tax rate increases or without the use of other offsets, such as elimination of the deduction for state and local taxes.

The ideal solution would be to address the AMT in the context of a complete overhaul of the income tax, such as the proposal made by the President's Advisory Panel on Federal Income Tax Reform. Although the AMT is probably the best example of pointless complexity in the tax system, it is far from the only one. Addressing all of the sources of complexity, unfairness, and inefficiency in the tax system at the same time would strengthen the income tax—the major source of federal tax revenues—at a time when unprecedented demands are about to be placed on the federal government because of the impending retirement of the baby boomers.

That said, the perfect should not be the enemy of the good. Many of the incremental options I have outlined here would significantly improve our tax system.

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