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Questions and Answers on the Alternative Minimum Tax

by Gerald Prante

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Q: What is the AMT?

A: AMT stands for "alternative minimum tax." It's IRS Form 6251, similar to the infamous IRS Form 1040 but with different rules and rates. Taxpayers must calculate their tax liability using both forms and then pay the higher of the two calculations. The AMT was created in 1969 when the Treasury Secretary reported that 155 high-income people had managed to legally pay nothing by earning all their income from tax-free sources.

Here's the IRS's basic definition of the AMT: http://www.irs.gov/taxtopics/tc556.html

Q: Whose idea was the alternative minimum tax?

A: Early versions were put forth by the Johnson Treasury, as well as by Robert F. Kennedy during his 1968 presidential campaign. Weeks before his assassination, Kennedy outlined his ideas for the tax code, which included a one-line version of the alternative minimum tax. Each taxpayer would have multiplied his adjusted gross income by 20 percent, and that would have been the lowest amount he could owe. The version that ultimately passed a year later was quite different and far more complex.

For more detail about the history of AMT and RFK's plan:
http://www.taxfoundation.org/blog/show/22495.html
http://www.taxfoundation.org/blog/show/22490.html

Q: What percentage of American taxpayers had to pay extra because of the AMT in 2006?

A: Most people who filled out the AMT form discovered that they didn't owe more, so they just paid the amount due on the 1040. About three percent (4.3 million returns) owed more on the AMT. In almost every case, they were high-income people ($150,000 to $500,000) who claimed lots of exemptions, deductions and credits on Form 1040, which pushed their regular tax liability below what they owed under the AMT.

Q: I thought the AMT was a millionaire's tax. Why is it that most of the people paying AMT earn between $150,000 and $500,000?

A: People earning more than $500,000 find themselves owing more on the 1040 than the AMT for two reasons. The top two rates on Form 1040-33 and 35 percent-apply to all taxable income over $200,000. Those are higher than the AMT rates, so as annual income surpasses $500,000, it is likely that the taxpayer will owe more in regular tax liability than on the AMT. Also, millionaires filling out Form 1040 find that the law has taken away many of the exemptions, deductions and credits that can cause AMT liability to be higher.

Q: What most commonly pushes a taxpayer's regular tax liability on Form 1040 below what he owes under the AMT, making him an AMT filer?

A: The most common cause is the deduction for state and local taxes paid. Form 1040 permits a taxpayer to subtract what he paid to his state government in either income or sales taxes, in addition to what he paid his local government in property taxes. This lowers the taxpayer's federal income tax quite a bit, especially if he lives in a high-tax state and county. But the AMT doesn't permit those deductions, so people in high-tax states and counties (see question about states below) are most likely to have to pay the AMT.

Q: Aside from the state-local deduction, what other lines on the 1040 push a taxpayer's 1040 liability below AMT liability?

A: Having a large family can greatly reduce tax due on the 1040, pushing a taxpayer into AMT. The regular tax has a personal exemption amount of $3,400 per family member. Under AMT, the exemption is larger but doesn't change with family size.

Another AMT trigger is income from some tax-exempt municipal bonds, tax-free on the 1040 but not under the AMT. Finally, there's a host of large miscellaneous deductions on Schedule A of the 1040 that are not permitted under the AMT.

To view the entire list of preference items that are taken back by AMT, take a look at Form 6251: http://www.irs.gov/pub/irs-pdf/f6251.pdf

Q: Is AMT a widespread problem?

A: According to the most recent IRS data (2005), most AMT filers are clustered in high-income, high-tax states. Taxpayers in California, New York, New Jersey, Maryland and Connecticut filed 24.2 percent of all tax returns but 44.2 percent of all AMT returns.

As a percentage of each state's tax returns, AMT returns were most common in New Jersey and New York (over 6%), and Connecticut and DC (over 5%). They were least common in Mississippi, South Dakota, Tennessee, and Alaska (below 1%). Many political commentators have observed that the AMT has been mostly a "blue-state" issue.

To see which states in 2005 (latest IRS data) were hit hardest by AMT:
http://www.taxfoundation.org/publications/show/2125.html

Q: What is scheduled to happen to AMT in 2007?

A: In 2006, the AMT exempted a large amount of income. For singles, the first $42,500 was tax-free, and for married couples the first $62,550 was tax-free. That's why the AMT hasn't yet become a "middle-class" issue but instead a concern of people in the top echelon of the nation's wage earners.

However, the 2007 exemption amount is scheduled to drop from $42,500 to $33,750 for singles and from $62,550 to $45,000 for couples. Those are still hefty exemptions, but they wouldn't prevent millions more people from paying the AMT. Instead of 4.3 million AMT returns, there would be 23 million, and instead of collecting $25 billion, the AMT would collect $73 billion. Truly middle-income workers would still be protected by the exemption, but many upper-middle income people would suddenly have to deal with the AMT.

For a critique of how the "middle class" terminology has been used throughout this debate:
http://www.taxfoundation.org/blog/show/22367.html

Q: Does AMT make the tax system more or less progressive?

A: The AMT makes the tax system dramatically more progressive by extracting additional, sizeable tax payments from people who make between $150,000 and $500,000. Even if more upper-middle-income people start having to pay the AMT, it will remain one of the most progressive elements of the income tax code. The Joint Committee on Taxation says that in 2010, even if the AMT exemption level falls and 31 million AMT returns are filed, 88 percent of the collections will still come from tax returns with adjusted gross incomes of greater than $100,000.

Q: How have the tax cuts passed in 2001 and 2003 affected AMT?

A: They dramatically reduced people's liability on Form 1040. For some taxpayers, the savings were enough that their AMT liabilities, which had always been lower than their 1040 liabilities, were now higher. Even those people saved money from the tax cuts though.

For a table showing how taxpayers who are scheduled to be hit with AMT in 2007 under current law would have fared differently had the Bush tax cuts not been passed: http://www.taxfoundation.org/taxdata/show/22424.html

Q: Is anyone paying more taxes in total as a result of being pushed into AMT by the Bush tax cuts?

A: No, everyone paid more in 2000 under the Clinton-era rates than in 2006 under the Bush-era rates. The tax savings from the Bush tax cuts can be reduced by the AMT but not wiped out. Here's a simple illustration:

Suppose a restaurant that used to charge $10 for a hamburger or cheeseburger (same price for both) dropped its prices and instead charged $7 for the hamburger plus $1 extra for cheese. Every consumer is better off, but there will inevitably be cheeseburger lovers who cry about the extra $1 charge for cheese. Either they are unaware of the old prices or they just don't like being singled out. Those are today's AMT filers, paying extra for the AMT but still paying a much smaller total than they used to.

To learn more about how the Bush tax cuts have interacted with AMT, check out this *Fiscal Fact* on the issue: http://www.taxfoundation.org/research/show/22425.html.

Q: Many politicians are urging repeal or reform of the AMT. What does the Tax Foundation believe is the best policy?

A: The Tax Foundation's ideal policy would be to eliminate the AMT as part of a fundamental reform of the federal income tax system. The overall theme of fundamental tax reform should be applying tax rates to more types of income at lower rates. This is what tax reformers mean when they advocate broadening the base and lowering the rates.

Q: How much would repealing AMT cost in terms of foregone revenue?

A: The Joint Committee on Taxation estimates that a complete repeal of AMT by itself would cost $872.3 billion over ten years (2007 - 2017). In Fiscal Year 2008 alone, that figure would be $113.1 billion. Source: http://www.house.gov/jct/x-38-07.pdf

Q: Is there some action short of dramatic, fundamental tax reform that would be useful?

A: Yes, we could enact a fix to the AMT that would fall far short of fundamental reform but would nevertheless improve the tax system, even in today's politically contentious environment.

Not all of the AMT's features are bad (it does disallow some unjustified deductions), but it disallows many legitimate deductions like business expenses, and it adds a new maze of complexity to an already labyrinthine tax code. So any fix should at least greatly reduce the role of the AMT without raising tax rates on income that is already heavily taxed. We have published a plan that would do this: http://www.taxfoundation.org/publications/show/22449.html

Q: Why doesn't the Tax Foundation plan repeal the AMT entirely?

A: Outright repeal sounds good, but it has two side effects. First, unless the new PAYGO rules are waived by the Congress or spending is cut dramatically, the repeal must be "paid for," i.e., taxes must be raised elsewhere to offset the AMT relief. Therefore, the more AMT relief Congress provides, the more they are likely to either raise someone's tax rates (as suggested by Rep. Richard Neal of the House Ways and Means Committee), or cut back someone's deductions, as we suggest. Of these two options, we believe the economy as a whole will perform better if deductions are repealed.

The *Washington Post* explained the Neal surtax plan: http://www.washingtonpost.com/wp-dyn/content/article/2007/06/07/AR2007060702146_pf.html.

Q: Aside from the need to satisfy PAYGO rules, is there any other reason the Tax Foundation plan leaves a small piece of the AMT in place for people earning several hundred thousand dollars?

A: We must keep an eye on those loophole sources of income that are currently patched by the AMT. That is, with total repeal, we might end up on square one with the problem that the AMT was originally enacted to fix: high-income people paying no tax because they earn all their income from tax-exempt sources.

For more on the income streams that escape tax on the 1040 but not on the AMT: http://www.taxfoundation.org/publications/show/22400.html

Q: What is likely to happen this year with regard to AMT policy?

A: It is impossible to predict tax policy, or anything on Capitol Hill for that matter, but most analysts believe that a two-year patch (a higher exemption level) with no offsetting revenue hikes is the most likely outcome. (Passage of such a law would require House PAYGO rules to be suspended.) Then the issue will need to be taken up again for tax years 2009 and 2010. In 2011, the expiration of the tax cuts will reduce the need for any action on AMT, putting more focus on the regular tax side as nearly everyone's taxes will be increased from 2010 to 2011 under current law.

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Tax Foundation
2001 L Street NW, Suite 1050
Washington, DC 20036
Ph: (202) 464-6200
Fax: (202) 464-6201
www.taxfoundation.org