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CRS Report for Congress

The Potential Distributional Effects of the Alternative Minimum Tax

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Summary

The alternative minimum tax for individuals (AMT) was originally enacted to ensure that high-income taxpayers paid a fair share of the federal income tax. However, the lack of indexation of the AMT coupled with the recent reductions in regular income taxes has greatly expanded the potential impact of the AMT.

Temporary increases in the AMT exemption and provisions which allow taxpayers to apply nonrefundable tax credits against their AMT liabilities expired at the end of 2007. Certain taxpayers will be more adversely affected than others. In general, married taxpayers filing joint returns will be more adversely affected than single taxpayers. In addition, taxpayers with large families will be more adversely affected than taxpayers with small families.

In terms of income, the largest increase in taxpayers subject to the AMT will occur over adjusted gross income (AGI) ranges of $100,000 to $500,000. Taxpayers with AGIs between $50,000 and $100,000 will eventually be affected, with the negative effects of the AMT growing substantially over time. Taxpayers with AGIs above $500,000 will not be significantly affected by the expiration of the higher AMT exemption.

This report will be updated as legislative action warrants or as new data become available.

Background

The alternative minimum tax (AMT) for individuals was originally enacted to ensure that all taxpayers, especially high-income taxpayers, paid at least a minimum amount of federal taxes. However, absent legislative action, there will be a significant increase in the number of middle- to upper-middle-income taxpayers affected by the AMT in the near future. In 2006, about 4.2 million taxpayers were subject to the AMT, but by 2008, the

Joint Committee on Taxation (JCT) estimates that up to 25.7 million taxpayers could be subject to the AMT.[1]

There are two main reasons for the increase in the number of taxpayers affected by the AMT. First, under the regular income tax, the tax brackets, standard deductions, and personal exemptions are indexed for inflation. The AMT tax brackets and basic exemptions are not indexed. Over time this has produced a reduction in the differences between regular income tax liabilities and AMT liabilities at any given nominal income level, differences that will continue to shrink in the absence of AMT indexation. The second reason is that the 2001 and 2003 reductions in the regular income tax further narrowed the differences between regular and AMT tax liabilities. The combination of these two factors means that, absent legislative changes, there will be significant growth in the number of taxpayers affected by the AMT.[2]

The effects of the AMT have been mitigated through temporary increases in the basic exemption for the AMT and temporary changes that allow taxpayers to use nonrefundable personal tax credits to reduce their AMT liabilities. The most recent increase in the basic AMT exemption occurred in December 2007 with the enactment of the Tax Increase Prevention Act of 2007 (TIPA, P.L. 110-166). Under provisions of this act, the AMT exemption for 2007 was set at $66,250 for joint returns and $44,350 for unmarried taxpayers. In addition, this act allows taxpayers to temporarily use nonrefundable tax credits to offset AMT liability. The Joint Committee on Taxation estimates that these two changes will reduce federal revenues by almost $50.6 billion. In 2008, the basic AMT exemption is scheduled to decrease to its prior law level of $45,000 for joint returns ($35,750 for unmarried taxpayers) and nonrefundable tax credits will not be allowed to offset AMT liability.

Who Will be Subject to the AMT in the Future?

For 2008, the basic exemption for the AMT has reverted to its lower prior-law levels and nonrefundable personal tax credits are not allowed against the AMT. As a result, there will be a significant increase in the number of taxpayers subject to the AMT, and there will also be a significant change in the types of taxpayers who will be subject to the AMT. The potential distributional effects of the AMT are summarized below.

- Married taxpayers filing joint returns will be more likely to fall under the AMT than will taxpayers filing as singles or heads of households. This occurs because, in 2001, taxpayers filing joint returns received more generous reductions in their regular income tax liabilities than did taxpayers filing as singles or heads of households. As a result, at any given income level, taxpayers filing joint returns have seen their regular income tax liabilities reduced to levels that are near or actually below their AMT liabilities.

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[1] U.S. Congress. Joint Committee on Taxation. *Present Law and Background Relating to the Individual Alternative Minimum Tax,* JCX-38-07, June 25, 2007.

[2] For more detailed information on the AMT see CRS Report RL30149, *The Alternative Minimum Tax for Individuals*, by Steven Maguire.

- Larger families will be more likely to fall under the AMT than will smaller families. This occurs because personal exemptions, which are allowed under the regular income tax, are not allowed under the AMT.

- Taxpayers who itemize their deductions under the regular income tax and who have large itemized deductions for state/local taxes will be more likely to fall under the AMT than will taxpayers who do not itemize their deductions or taxpayers who take only small deductions for state/local taxes. This occurs because deductions for state/local taxes are not allowed under the AMT.[3] Taxpayers in high-tax states who claim itemized deductions for state/local taxes will be more likely to fall under the AMT than taxpayers in low-tax states who claim little or no deductions for state/local taxes. Hence, taxpayers in high-tax states such as New Jersey, New York, Connecticut, District of Columbia, and Maryland will tend to be more adversely affected by the AMT than will taxpayers in low-tax states such as South Dakota, Mississippi, Tennessee, Alaska, and Alabama.[4]

- In 2008, even taxpayers who do not itemize their deductions on their regular income tax returns will be subject to the AMT at relatively modest income levels. For instance, taxpayers filing joint returns with two children (four personal exemptions) will be subject to the AMT when their incomes exceed approximately $65,114. Taxpayers filing joint returns with no children (two personal exemptions) will be subject to the AMT when their incomes exceed approximately $74,660.[5]

Table 1 shows the effects of the AMT by adjusted gross income (AGI) levels for selected years between 2005 and 2010 (data for 2006 is not available).

- In 2006, taxpayers with AGIs in the $200,000 to $500,000 range were the most affected by the AMT. Almost 74% of taxpayers in this income range had AMT liabilities.

- In 2008 and beyond, taxpayers with AGIs in the $100,000 to $500,000 range will be the most affected by the AMT. By 2010, more than 86% of the taxpayers with AGIs of $100,000 to $200,000 will be subject to the AMT. Approximately 98.1% of taxpayers with AGIs in the $200,000 to $500,000 range will be subject to the AMT.

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[3] In addition to disallowing deductions for state/local taxes, the AMT does not allow miscellaneous itemized deductions and allows deductions for medical expenses only to the extent that they exceed 10% of AGI .

[4] See CRS Report RL32942, *State and Local Taxes and the Federal Alternative Minimum Tax*, by Steven Maguire, and CRS Report RS22083, *Alternative Minimum Taxpayers by State: 2004, 2005 and Projections for 2008*, by Steven Maguire.

[5] For more information see CRS Report RS21817, *The Alternative Minimum Tax (AMT): Income Entry Points and "Take Back" Effects*, by Gregg Esenwein.

- The number of taxpayers with AGIs in the $50,000 to $100,000 range who will fall under the AMT will grow steadily over the 2007 to 2010 period. By 2010, over 41% of the taxpayers in this income range will be subject to the AMT.

- The number of very high-income taxpayers (AGIs over $1,000,000) subject to the AMT will increase over the 2006 through 2010 period.

To reiterate, it is the lack of indexation of the AMT combined with the reductions in the regular income tax that are the primary factors responsible for producing these results for taxpayers with AGIs between $50,000 and $500,000.

Table 1. Taxpayers With AMT Liability by Adjusted Gross Income in 2006 and 2010

Adjusted Gross Income	2006	2010
Less than $20,000	0.0%	0.0%
$20,000 to $40,000	0.0%	0.6%
$40,000 to $50,000	0.2%	5.5%
$50,000 to $75,000	0.5%	17.4%
$75,000 to $100,000	1.6%	52.9%
$100,000 to $200,000	10.2%	85.6%
$200,000 to $500,000	74.0%	98.1%
$500,000 to $1,000,000	47.3%	70.9%
$1,000,000 and above	23.1%	31.5%
All taxpayers	2.5%	17.9%

Source: U.S. Congress. Joint Committee on Taxation. *Present Law and Background Relating to the Individual Alternative Minimum Tax,* JCX-38-07, June 25, 2007.

The Joint Committee on Taxation recently released data that confirms the distributional effects of the interaction between the recent reductions in the regular income tax and the AMT.[6] This data shows, with the AMT and without the AMT, the static change in tax liability that would occur by adjusted gross income (AGI) class if certain portions of the 2001 and 2003 tax cuts were repealed. The JCT findings are shown in **Table 2**.

For example, **Table 2** shows that taxpayers with AGIs between $100,000 and $200,000 would receive $53.1 billion in tax reductions from the 2001 and 2003 tax

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[6] U.S. Congress. Joint Committee on Taxation, "Tabulations," memorandum of May 18, 2007.

reductions if there were no AMT. But because of the interaction of the AMT and the regular income tax, this income group would receive only $28.5 billion in tax reductions. Hence, the AMT takes back $24.8 billion or 46.5% of the regular income tax reductions for this income group.

Table 2. Interaction Between the AMT and Recent Reductions in the Regular Income Tax: The "Take Back" Effect for Tax Year 2008

Adjusted Gross Income (000s)	Repeal of certain provisions of the 2001 and 2003 tax reductions - static change in tax liability assuming no behavioral response			
	Change in income tax liability assuming no AMT (billions)	Change in income tax liability including the AMT (billions)	Dollar "take back" effect of AMT	Percentage "take back" effect of AMT*
$0 - $20	$6.3	$6.3	$0	0%
$20- $40	$26.5	$26.5	$0	0%
$40 - $50	$10.6	$10.5	$0.1	0.9%
$50 - $75	$24.5	$23.7	$0.8	3.3%
$75 - $100	$25.1	$19.7	$5.3	21.5%
$100 - $200	$53.3	$28.5	$24.8	46.5%
$200 - $500	$37.4	$13.7	$23.7	63.4%
$500 - $1,000	$20.5	$17.3	$3.2	15.6%
over $1,000	$64.9	$62.6	$2.2	3.5%

Source: Joint Committee on Taxation. *Calculated by CRS.

Table 2 also shows that the most significant interaction between the AMT and the reduction in the regular income tax occurs for taxpayers with AGIs in the $75,000 to $500,000 income range. For these taxpayers, the AMT takes back from 22% to 63% of the recent reductions in the regular income tax. Taxpayers with AGIs in excess of $1 million are much less affected by the AMT, losing only about 3.5% of the reductions in the regular income tax to the AMT.

Why Are Very High-Income Taxpayers Not So Adversely Affected by the AMT?

Although the AMT was originally intended to make sure that *high-income* taxpayers paid at least a minimum amount of federal income taxes, they will not be the group that will be the most adversely affected by the AMT in the future. There are several reasons why high-income taxpayers, especially those with adjusted gross incomes (AGIs) over $500,000, will be less affected by the AMT than their lower-income counterparts.

First, for high-income taxpayers, the marginal tax rates they face under the regular income tax tend to be higher than the marginal tax rates they face under the AMT. For example under the regular income tax, the top two marginal income tax rates are 33% and 35%. The top rate under the AMT is 28%.

Second, under the regular income tax, personal exemptions are phased out for high-income taxpayers. So the fact that personal exemptions are not allowed under the AMT does not have a significant effect on high-income taxpayers who do not get personal exemptions under the regular income tax.

Third, under the alternative minimum tax, the basic AMT exemption is phased out for taxpayers filing joint returns when AMT taxable income exceeds $150,000.[7] Hence, many high-income taxpayers do not get a basic exemption under the AMT. Therefore, the reduction in the basic AMT exemption will have no effect on their AMT liabilities.

Finally, high-income taxpayers generally derive a significant percentage of their total income from capital gains and dividend income. Under both the regular income tax and the AMT, the tax rate on long-term capital gains and dividend income is limited to a maximum rate of 15%.

[7] The basic AMT exemption is phased out for taxpayers with AMT taxable incomes in excess of $150,000. In 2008, the basic AMT exemption of $45,000 for joint returns is completely phased out at income levels in excess of $330,000.