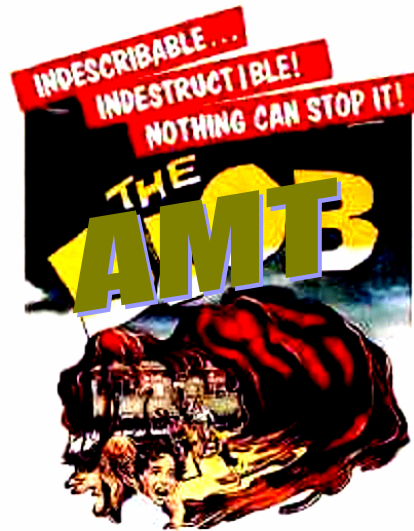




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*AEI + TPC
April 16, 2007*

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The Individual Alternative Minimum Tax: Options for Reform

*American Enterprise Institute
April 16, 2007*

Leonard E. Burman
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Director, The Tax Policy Center

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Background

- 1966: 155 high-income taxpayers paid no income tax
- 1969: Congress created a minimum tax designed to prevent excessive income tax avoidance by high-income families
- 2010: The AMT will affect 32 million taxpayers, including virtually all upper middle class families with two or more kids

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Calculation of AMT Liability

- Add AMT preferences and adjustments to taxable income
- Subtract AMT exemption
- Recalculate tax using AMT rates
- If more than regular tax, pay the difference as AMT
- (Many complexities left out of this simplified explanation.)

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AMT Exemption and Rates

- Absent a change in law, the AMT exemption will fall from \$62,550 for married couples filing a joint return and \$42,500 for single filers in 2006 to \$45,000 and \$33,750 in 2007
- The exemption phases out at higher incomes, creating high implicit tax rates
- Statutory tax rates of 26% and 28%, phantom rates of 32.5% and 35% due to the phaseout
- Neither the exemption nor brackets are indexed for inflation

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AMT Exemptions and Rates

Exemption

	<u>2006</u>	<u>After 2006</u>	<u>Threshold for Phase-Out</u>
Married Couples, joint	\$62,550	\$45,000	\$150,000
Singles	\$42,500	\$33,750	\$112,500

Schedule

	<u>\$0 - \$175,000</u>	<u>Above \$175,000</u>
Married couples and singles	26%	28%

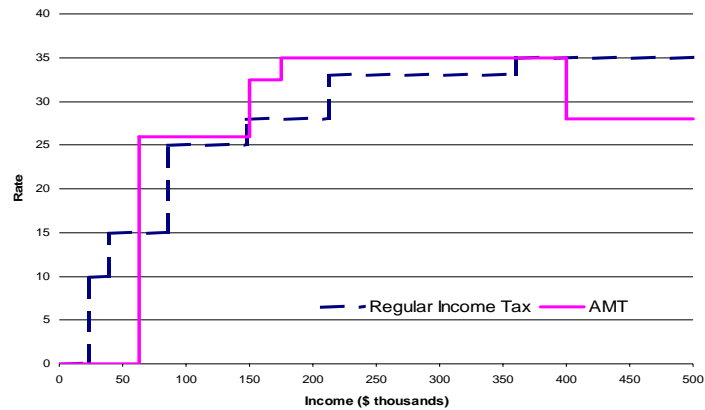
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Rate Schedule for Couples, AMT vs. Regular Tax: 2006



Note: Figure assumes married couple filing jointly with two children claiming standard deduction against regular income tax and no other deductions or credits. All income is from wages. Figure does not show the effect of the personal exemption phase-out under the regular tax.

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AMT Preferences, 2004

- State and local tax deductions (68% of total)
- Personal exemptions (19%)
- Miscellaneous deductions (14%)
- Net operating losses (13%)
- Incentive stock options (2%)
- Passive activity loss (1%)

Note: The items shown are the six largest preferences (by dollar amount) and the only items exceeding half of 1 percent of the total. The sum adds to more than 100 percent because some adjustments not shown, such as state tax refunds, are negative.

Source: Office of Tax Analysis, Department of the Treasury (unpublished tabulation)

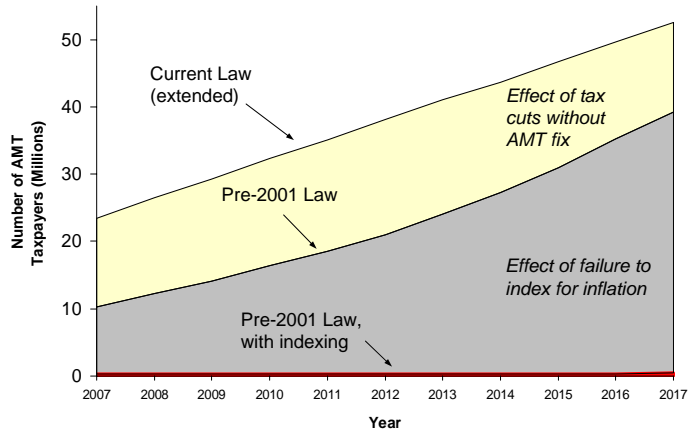
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Causes of AMT Growth



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

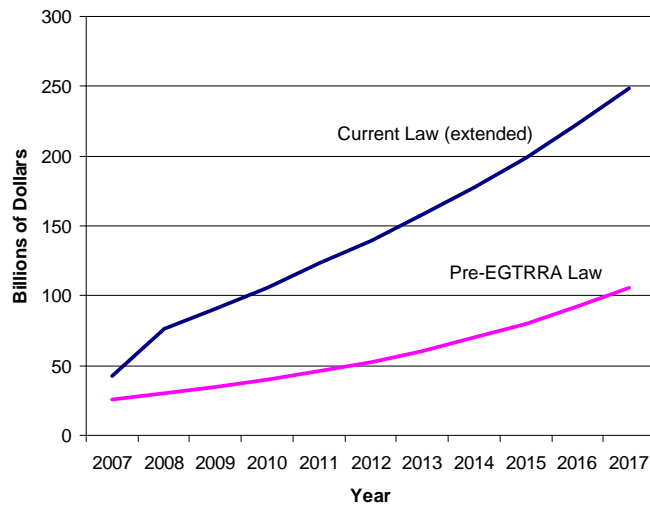
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AMT Revenue, FY2007-17



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

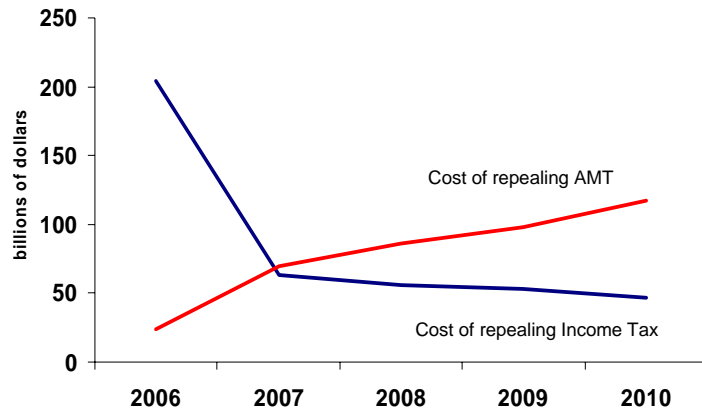
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Cost of Repealing the AMT



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

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AMT Projections

- Current-law AMT revenue exceeds \$850 billion between fiscal year 2007 and 2017
- If the tax cuts are extended after 2010 AMT revenue will total nearly \$1.6 trillion
- Only 4% of taxpayers were affected by the AMT in 2006, but that share is scheduled to rise to 26% in 2007 and 34% in 2010 under current law

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AMT Demographics (2010)

- The AMT disproportionately affects married couples and families with children
 - 48% of couples vs. 4% of singles on AMT
 - 89% of couples with 2 or more kids and AGI between \$75,000 and \$100,000 on AMT
- Residents of high-tax states are 7 percentage points more likely to be on AMT than those in low-tax states

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AMT Projections by Individual Characteristics

Characteristic	Percent on AMT		
	Current Law		
	2006	2007	2010
Percent of Taxpayers	4.0	25.9	33.6
Percent of Tax Filers	2.8	18.4	24.5
by Filing Status			
Single	0.9	2.4	3.8
Married Filing Joint	5.1	36.7	47.9
Head of Household	1.3	10.4	17.0
Married Filing Separate	5.7	34.5	47.4

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

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AMT Projections by Individual Characteristics

Characteristic	AMT Participation Rate (percent)		
	Current Law		
	2006	2007	2010
Filers By State Tax Level*			
Low	1.6	15.3	21.1
Middle	2.3	18.5	25.0
High	4.6	21.8	27.7
Filers by Number of Children			
0	1.9	11.4	16.8
1	2.7	24.8	32.4
2	5.0	34.5	42.0
3 or more	7.4	39.6	48.4
Married Couple, 2+ kids, 75k<AGI<100k	0.8	78.2	88.6

*Excludes effect of state sales tax deduction.

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

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AMT Projections by Income

Cash Income (thousands of 2006\$)	AMT Participation Rate (percent)		
	Current Law		
	2006	2007	2010
Less than 30	0.0	0.0	0.0
30-50	0.0	1.3	3.0
50-75	0.2	9.0	17.1
75-100	0.7	36.2	49.9
100-200	4.8	70.8	80.4
200-500	50.9	89.7	94.3
500-1,000	49.3	57.2	72.2
1,000 and more	31.4	33.8	38.8

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

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Drifting Off Target

- Though intended to make high-income people pay tax, AMT will increasingly hit middle class
 - Over 80% of AMT taxpayers will have income < \$200K in 2010
 - More than 1/3 have income < \$100K
 - 50% of families earning \$75-100K will be on the AMT but only 39% of those earning over \$1 million
 - Those earning \$100-200K more than twice as likely as millionaires

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Problems with the AMT

- Good Tax Policy is...
 - Simple
 - Efficient
 - Fair
- The AMT violates all of these principles.

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Pointless Complexity

- Many middle class taxpayers must file AMT Form 6251, but owe no AMT
- AMT rules regarding credits, capital gains, dividends, deferral preferences very complex
- Most deferral preferences don't even generate much revenue, just change the timing of tax payments
- Vastly complicates tax planning

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Efficiency

- The AMT *raises* marginal tax rates for most
 - 71% of AMT taxpayers faced *higher* marginal tax rates under AMT in 2006
 - 89% will be in that situation in 2010
 - People creep into higher brackets over time because, unlike the regular income tax, AMT is not indexed
- Might enhance efficiency to extent that it deterred tax shelters, but 90% of AMT preferences have nothing to do with shelters

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Percent of AMT Taxpayers who Face Higher Marginal Tax Rates Under the AMT

Cash Income (Thousands of \$2006)	2006	2010
All Taxpayers	71.3	89.0
Less than 30	99.8	93.1
30-50	99.4	95.9
50-75	98.2	90.3
75-100	93.1	92.1
100-200	85.5	92.0
200-500	73.9	83.3
500-1,000	29.8	25.9
More than 1,000	33.5	34.3

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

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Equity

- Nasty marriage/child penalties
- Some legitimate adjustments to ability to pay are disallowed under AMT (e.g., contingent legal fees)
- AMT makes the tax system more progressive, but less so over time
- Relatively little tax collected from very rich

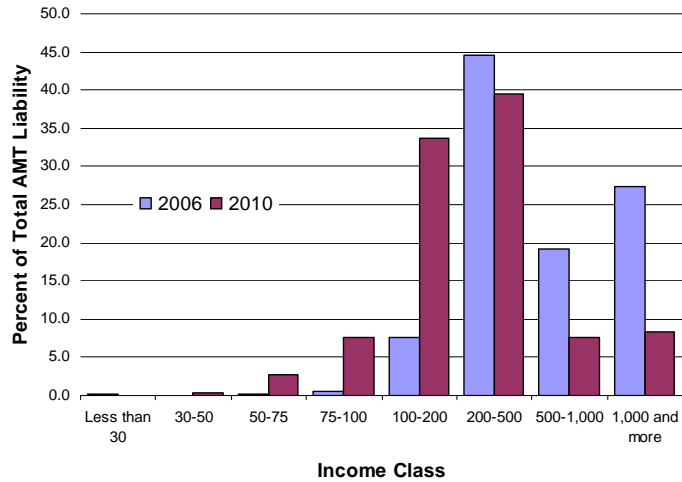
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Distribution of AMT Liability: 2006 & 2010



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

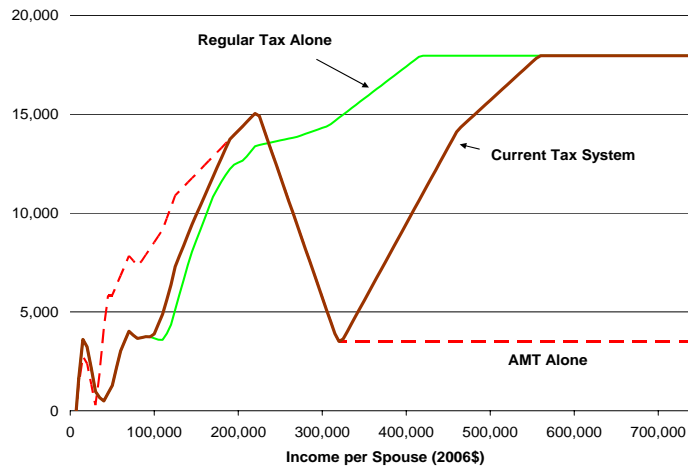
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Effect of AMT on Marriage Penalties (2 spouses, equal incomes)



Note: Taxpayers on AMT in grey area. Assumes: 2 earners and two kids qualifying for child credit and EITC; household files jointly if married, and as head of household with 2 kids and single if not.

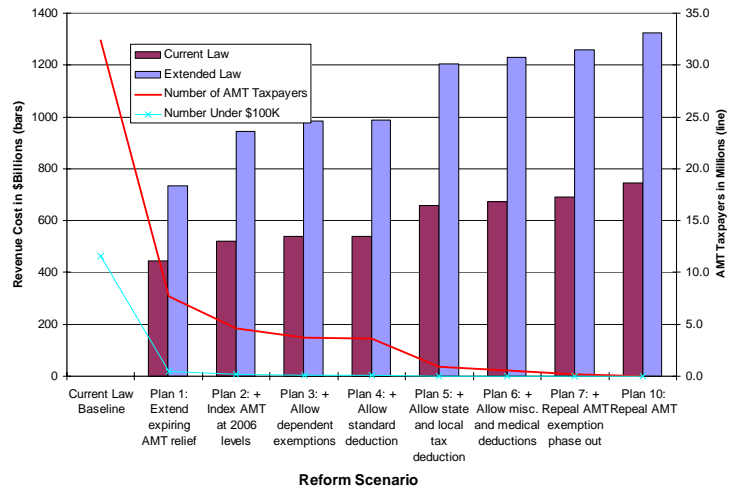
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Reform Options: 10-Year Revenue Cost and Number of AMT Taxpayers in 2010



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

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Options to Finance Repeal

Option	Top Rate (%)
Raise all rates 6%	37.0
Raise top 3 rates 15%	40.4
Repeal state and local tax deduction and <i>cut</i> rates 2%	34.3
Repeal S&L tax deduction and cut top rates 5%	33.1
Roll back cg rates, increase top 3 rates, extended	42.8

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AMT Reform Options

Option	Top Rate (%)	Number AMT Taxpayers (millions)	
		All	Under \$100K
(1) Index exemption	39.1	2.4	0.1
(2) = (1) + dep. ex.	39.2	1.7	0.1
(3) = (2) + deductions	39.9	0.3	0.0
(4) + retarget	37.7	1.2	0.0

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AMT Reform: % Reduction in Participation and New Top Rates, by Financing Option

Reform Option	Quintile			In Top 10 Percent			Top Rate (2007)
	Q3	Q4	Q5	T10	T5	T1	
(1) Index AMT exemption							
Top 3 Rates	-99	-98	-88	-82	-71	-49	39.1
Rates+CG	-99	-98	-78	-66	-45	-7	35.8
(2) = (1) + dependent exemptions							
Top 3 Rates	-100	-99	-92	-87	-78	-52	39.2
Rates+CG	-100	-99	-82	-72	-54	-13	35.9
(3) = (2) + standard and itemized deductions							
Top 3 Rates	-100	-100	-98	-97	-95	-80	39.9
Rates+CG	-100	-100	-94	-90	-83	-53	37.4
(4) = (3) + flat 28 percent AMT rate, no exemption phaseout							
Rates+CG	-100	-100	-94	-90	-84	-59	37.7

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Conclusions

- Pointless complexity and bizarre pattern of taxes
- Increasingly a tax on the upper middle class
- Numerous options exist to make up lost revenue
- Silver bullet does not exist

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Indexing, Tax Cuts, and the AMT

Example for a married couple with two kids and constant real income

	2000	2010 Without Tax Cuts	2010
Calculate Regular Tax (before AMT)			
<i>Add Income Sources</i>			
Wages	\$74,000	\$94,026	\$94,026
Interest	\$1,000	\$1,271	\$1,271
<i>Subtract Deductions</i>			
Personal exemptions	\$11,200	\$14,600	\$14,600
State and local taxes	\$6,300	\$8,005	\$8,005
Other itemized deductions	\$9,450	\$12,007	\$12,007
Taxable Income	\$48,050	\$60,684	\$60,684
Regular Income Tax (before credits)	\$7,754	\$9,621	\$8,268
Average Tax Rate	10.3	10.1	8.7
Calculate Tentative AMT			
<i>Add Preference Items to Taxable Income</i>			
Taxable Income	\$48,050	\$60,684	\$60,684
Personal exemptions	\$11,200	\$14,600	\$14,600
State income and property tax	\$6,300	\$8,005	\$8,005
<i>Subtract Deductions</i>			
AMT exemption	\$45,000	\$45,000	\$45,000
Taxable Under AMT	\$20,550	\$38,289	\$38,289
Tentative AMT	\$5,343	\$9,955	\$9,955
AMT (tentative AMT less regular tax)	\$0	\$335	\$1,688
Average Tax Rate with AMT	7.1	10.4	10.4
Addendum			
AMT liability (tentative AMT less regular tax)	\$0	\$335	\$1,688
Income tax after credits	\$6,754	\$8,955	\$7,955
Average tax rate after credits	9.0	9.4	8.3

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See next slide for discussion.



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Indexing, Tax Cuts, and the AMT

- Indexing holds regular income tax (before credits) approximately constant as percent of income
- Tentative AMT jumps from 7.1% to 10.4% of income because AMT exemption is not indexed.
- Before AMT, 2001-06 tax cuts result in rate reduction of 1.6 percentage points
- AMT takes away all of tax cuts except for the child credit.
- Net reduction in tax rate because of the tax cuts is only 0.7 percentage points because the taxpayer is now subject to the AMT

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