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The Alternative Minimum Tax for Individuals

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Summary

Over time, the individual income tax has been used as a vehicle to promote various social and economic goals. This has been accomplished by according preferential tax treatment to certain items of income and expense. The net result, however, has been that by taking advantage of the preferences and incentives in the tax code, some individuals can substantially reduce their income taxes.

To make sure that everyone paid at least a minimum of taxes and still preserve the economic and social incentives in the tax code, Congress, in 1969, enacted the individual alternative minimum tax (AMT). It is calculated in the following manner. First, an individual adds back various tax preference items to his taxable income under his regular income tax. This grossed up amount then becomes his tax base for the AMT. Next, the amount of the basic exemption is calculated and subtracted from the AMT tax base. A two-tiered tax rate structure of 26% and 28% is then assessed against the remaining AMT tax base to determine AMT tax liability. The taxpayer then pays whichever is greater, his regular income tax liability or his AMT tax liability. Finally, the AMT tax credit is calculated as an item to be carried forward to offset regular income tax liabilities in future years

Since its inception, the value and effectiveness of the minimum tax has often been the subject of congressional debate. Recently, the combined effects of inflation and the legislative reductions in the regular income tax enacted as part of the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) have increased congressional concern about the expanding impact of the alternative minimum tax. It is now estimated that if no changes are made to the AMT, then the number of taxpayers subject to the AMT will increase from less than 1 million in 1997 to over 35 million by 2010. Fixing the problem will be expensive. It is estimated that repealing the individual AMT would cost $600 billion over the 2002-2011 period. Indexation of the AMT would cost $370 billion over the same period.

This report will be updated as legislative action warrants.

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Over time, the individual income tax has been used as a vehicle to promote various social and economic goals. This has been accomplished by according preferential tax treatment to certain items of income and expense. The net result, however, has been an erosion in the individual income tax base. By taking advantage of the preferences and incentives in the tax code, some individuals can substantially reduce their income taxes.

To make sure that everyone paid at least a minimum of taxes and still preserve the economic and social incentives in the tax code, Congress, in 1969, enacted the individual alternative minimum tax (AMT). Since its inception, the value and effectiveness of the minimum tax has often been the subject of congressional debate. Recently, the combined effects of inflation and the legislated reductions in the regular individual income tax enacted as part of the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) have increased congressional concern about the effects of the alternative minimum tax. It is now estimated that if no changes are made to the AMT the number of taxpayers subject to the AMT will increase from around 605,000 in 1997 to over 35 million by 2010. Fixing the problem will be expensive. It is estimated that repealing the individual AMT would cost $600 billion over the 2002 to 2011 period while indexation of the AMT would cost $370 billion.[1]

This report provides a brief overview of the alternative minimum tax for individuals, discusses the issues associated with the current system, and describes current legislation to amend the AMT. The report will be updated as legislative action warrants.

Evolution of the Current System

The first individual minimum tax was enacted in 1969 and was an add-on minimum tax. That is, it was a tax that was paid in addition to the regular income tax. The tax rate for the add-on minimum tax was 10% and the tax base consisted of eight tax preference items, the most significant of which was the portion of capital gains income that was excluded from tax under the regular income tax.

Since its enactment in 1969, the individual minimum tax has been significantly modified numerous times, in 1971, in 1976, in 1977, in 1978, in 1982, in 1986, in 1990, in 1993, and in 2001. For example, the Tax Reform Act of 1976 added new preference items to the add-on minimum tax base and increased the tax rate to 15%.

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[1]For more information see *The Impact of the 2001 Tax Bill on the Individual AMT*, by Jerry Tempalski, U.S. Treasury Department. October 23, 2001.

Another major change occurred under the Revenue Act of 1978, which created the predecessor of the current alternative minimum tax (AMT). This was an entirely new tax which was assessed on a taxpayer's regular taxable income increased by certain itemized deductions and the excluded portion of capital gains income (capital gains income was dropped as a preference item under the add-on minimum tax). The tax rates on the alternative minimum tax ranged from 10 to 25%. The alternative minimum tax was payable to the extent that it exceeded the sum of the taxpayer's regular income tax liability and his add-on minimum tax liability.

Between 1978 and 1982, individuals were subject to both the add-on minimum tax and the alternative minimum tax. Citing the need to simplify the system and focus the tax on high-income taxpayers, Congress, in provisions contained in the Tax Equity and Fiscal Responsibility Act of 1982, repealed the add-on minimum tax, expanded the tax base of the alternative minimum tax, and changed the AMT tax rate to 20%.

The Tax Reform Act of 1986 substantially changed the alternative minimum tax. It increased the tax rate to 21%, changed the basic exemption amount, considerably broadened the tax base, and revamped the alternative minimum tax credit. It also introduced a phase-out of the AMT exemption amount for taxpayers whose AMT taxable income exceeded certain limits. For taxpayers filing joint returns the AMT exemption was reduced by 25% of the amount by which the taxpayer's AMT taxable income exceeded $150,000 ($112,000 for single taxpayers and $75,000 for married taxpayers filing separately, trusts, and estates).

By far, however, the most significant change affecting the AMT was indirect and resulted from modifications in the tax treatment of capital gains income under the regular income tax. Under pre-1986 law, 60% of a long-term capital gain was exempt from regular income taxes. The excluded portion of the gain, however, was taxable as a tax preference under the AMT. Since the 1986 Act repealed the exclusion for long-term capital gains income and capital gains income was taxed in full under the regular income tax, it was no longer taxed as a tax preference item under the AMT. This change substantially reduced the number of taxpayers subject to the AMT.

The Revenue Reconciliation Act of 1990 increased the AMT tax rate from 21 to 24%. The Revenue Reconciliation Act of 1993 made two major changes in the AMT. First, it increased the AMT exemption amounts from $40,000 to $45,000 for taxpayers filing joint returns, from $30,000 to $33,750 for taxpayers filing single returns, and from $20,000 to $22,500 for married taxpayers filing separately, estates, and trusts.

Second, it created a two-tiered tax rate structure for the AMT. A 26% tax rate is applicable to the first $175,000 of a taxpayer's alternative minimum taxable income in excess of the exemption amount and 28% on alternative minimum taxable income in excess of $175,000.

A more recent legislative change occurred in the Omnibus Consolidated and Emergency Supplemental Appropriations Act of 1998. This Act allowed the nonrefundable personal tax credits to offset an individual's regular income tax in full for tax year 1998 only, even though the personal tax credits might be larger than the amount by which the taxpayer's regular income tax exceeded his tentative minimum

tax. In addition, it repealed, for tax year 1998 only, the provision that reduced the additional child tax credit by the amount by which an individual's AMT exceeded his regular income tax liability.

Another legislative change in the AMT occurred in the The Ticket to Work and Work Incentives Improvement Act of 1999, H.R. 1180, which extended, through December 31, 2001, the existing law tax provision that allows individuals to offset their regular income tax by the full amount of their nonrefundable personal tax credits regardless of the AMT.

The Economic Growth and Tax Relief Reconciliation Act of 2001, H.R. 1836, permanently allowed the child tax credit, the adoption tax credit, and the IRA contribution tax credit to be claimed to the extent of the full amount of a taxpayer's regular income tax and alternative minimum tax.[2] The Act also temporarily increased the AMT exemption amount by $4,000 for joint returns ($2,000 for unmarried individuals) effective for tax years between 2001 and 2004. In tax year 2005, the AMT exemption amount reverts back to its previous levels.

The most recent legislative change occurred in the Job Creation and Worker Assistance Act of 2002 (P.L. 107-147). This Act extends the temporary provisions, first enacted in 1998, that allow individuals to use all personal tax credits against both their regular and AMT tax liabilities. This change is effective through December 31, 2003.

Calculating AMT Liability

The alternative minimum tax for individuals is calculated in the following manner. First, an individual adds back various tax preference items to his taxable income under his regular income tax. This grossed up amount then becomes his tax base for the AMT. Next, the amount of the basic exemption is calculated and subtracted from the AMT tax base. A two-tiered tax rate structure of 26 and 28% is then assessed against the remaining AMT tax base to determine AMT tax liability. The taxpayer then pays whichever is greater, his regular income tax liability or his AMT tax liability. Finally, the AMT tax credit is calculated as an item to be carried forward to offset regular income tax liabilities in future years.

Tax preference items that are added to the AMT tax base include tax-exempt interest on certain private-activity bonds and excess depletion deductions. Also, for most types of property placed in service before 1987, the excess of accelerated depreciation over straight-line depreciation is considered a tax preference item and is added to the AMT tax base.

In addition to the tax preference items, certain adjustments are made to deductions that were allowed under the regular income tax calculation of taxable

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[2]For a detailed discussion of changes affecting the child tax credit and the AMT see CRS Report RS20988, *The Child Tax Credit After the Economic Growth and Tax Relief Reconciliation Act of 2001*, by Gregg Esenwein. August 13, 2001.

income. For instance, for certain assets, depreciation rates under the AMT differ from the depreciation rates under the regular income tax. In some cases the differences will be positive and increase the AMT tax base, while in other cases, the differences will be negative and decrease the AMT tax base.

Another major adjustment to the tax base for the AMT involves itemized deductions that are allowed under the regular income tax. For purposes of the AMT a taxpayer cannot claim deductions for miscellaneous expenses, for tax payments to state, local, or foreign governments, and for medical expenses except to the extent they exceed 10% of adjusted gross income (as opposed to the 7.5% floor under the regular income tax). Also deductions for investment interest expenses are limited to net investment income.

Other adjustments to determine the AMT tax base include: for long-term contracts the percentage of completion method of accounting must be used rather than the completed contract or cash basis method of accounting; mining exploration and development costs must be capitalized and amortized rather than expensed; and the excess of the fair market value over the amount actually paid on incentive stock options must be included in the AMT tax base.[3]

Furthermore, the AMT tax base is not reduced by personal exemptions applicable under the regular income tax nor is it reduced by the standard deductions applicable under the regular income tax.

After the AMT tax base is calculated, the AMT exemption is subtracted prior to the calculation of AMT tax liability. For tax years between 2001 and 2004, the basic exemption for the AMT is $49,000 for joint returns, $35,750 for single returns, and $24,500 for joint returns filing separately. The exemption amounts, however, are phased out over certain income ranges. (These exemption amounts were temporarily increased by the 2001 Tax Act and are scheduled to revert, in 2005, to their prior law levels of $45,000 for joint, $35,750 for single, and $22,500 for joint returns filing separately.)

The AMT exemption is reduced by 25% of the amount by which a taxpayer's AMT taxable income exceeds certain threshold amounts. In the case of joint returns, the basic exemption starts to phase out at AMT taxable income levels in excess of $150,000 and is reduced to zero at AMT taxable income levels in excess of $330,000. For single returns, the exemption is phased out between AMT taxable income levels of $112,500 and $247,000.

Once the AMT tax base has been reduced by the applicable exemption amount, the AMT tax liability is determined by applying the AMT tax rate schedule. The AMT tax rate schedule is 26% of the first $175,000 of AMT taxable income in excess of any AMT exemption and 28% on any additional AMT taxable income. (For joint returns filing separately, the AMT tax rate schedule is 26% of the first $87,500 AMT taxable income in excess of any AMT exemption amount and 28% on any additional

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[3]For more information on the interaction of the AMT and incentive stock options see CRS Report RS20874, *Taxes and Incentive Stock Options*, by Jane G. Gravelle. April 4, 2001.

AMT taxable income). The AMT tax is then reduced by the alternative minimum tax foreign tax credit (FTC), the child tax credit, the adoption tax credit, and the IRA tax credit.

It is important to note that even though a taxpayer may not be subject to the AMT, it can still affect his regular income tax liability. The reason is that some personal tax credits under the regular income tax are limited to the amount by which regular income tax liability exceeds AMT liability. These credits include the dependent care credit, the credit for the elderly and disabled, the HOPE Scholarship and Lifetime Learning credit, and the D.C. homebuyer's credit. Thus, a taxpayer who has a regular income tax liability of $5,000 and $1,000 of these affected personal tax credits, will effectively see these regular income tax credits reduced by $300 if his AMT liability is $4,300.[4] (The Job Creation and Worker Assistance Act of 2002 allows taxpayers to offset their AMT liability by the full amount of their personal tax credits. This provision, however, expires after 2003.)

The final step in the process involves calculating the AMT tax credit, a multi-step operation. Essentially, the AMT credit is designed to prevent those preference items that represent tax deferrals (depreciation, for example) from being taxed one year under the AMT and again later under the regular income tax. The AMT tax credit can be carried forward to offset regular income tax liabilities in future years.

AMT Issues

Many analysts have voiced concern over the expected increase in the number of upper-middle income taxpayers who may be subject to AMT coverage in the near future. This increase in the number of taxpayers covered by the AMT will occur because of the combined effects of cumulative inflation and recent legislative changes to the regular income tax.

Under the regular income tax, the tax rate structure, the standard deductions, the personal exemptions, and certain other structural components are indexed so that they do not lose their real (inflation-adjusted) value over time. This prevents real income tax liabilities from increasing solely due to the effects of inflation.

The structural components of the AMT, however, are not indexed for inflation. This lack of indexation means that over time real AMT tax liabilities will increase because of inflation induced increases in items of nominal income and expense. The end result will be that the gap between tax liabilities under the regular income tax and the AMT will shrink and many taxpayers could end up subject to the unindexed AMT or experience reductions in their nonrefundable tax credits under the regular income tax.

For example, in 1993, a married couple with two children under 17 and a total income of $65,000 would have owed $9,035 in federal income taxes under the regular

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[4]The adoption tax credit, child tax credit, and the IRA tax credit are allowed to the full extent of the individual's regular and AMT tax liability.

income tax. Their tentative AMT tax liability would have been $5,200. Because of tax indexation of the regular income tax and the addition of the new child tax credit, in 1999, a married couple with two children under 17 and a total income of $65,000 will only owe $6,021 under the regular income tax. Their AMT liability, however, remains at $5,200. As shown by this example, indexation of the regular income tax combined with new tax credits has greatly narrowed the gap between regular income tax liabilities and AMT liabilities.

The potential problems of an indexed regular tax and an unindexed AMT have long been recognized by tax analysts. In 1997, approximately 605,000 taxpayers or about 1% of all taxpayers were subject to the AMT.

Preliminary estimates indicate that by 2010, when the effects of both inflation and the legislative changes contained in the Economic Growth and Tax Relief Reconciliation Act of 2001 are taken into account, the number of taxpayers falling under either the AMT or AMT limits on their tax credits under the regular income tax will grow to 35 million (33% of total taxpayers).

The individual income tax rate reductions and the marriage penalty tax relief provisions of the 2001 Act are expected to increase the number of taxpayers subject to the AMT. Indeed, many taxpayers in the middle income ranges will find that the AMT will "take back" much of the tax reductions contained in the 2001 Act.

To demonstrate the interaction of inflation, the EGTRRA 2001 tax reductions, and the AMT consider the following example of a married couple with four children who have a $80,000 income in 2002. Their pre-tax credit effective tax rate under the regular income tax would be 10.52% in 2002. Their pre-tax credit effective AMT tax rate would be 10%. They would not pay the AMT since their regular income tax liability exceeds their AMT liability. If the family receives four child tax credits at $600 per credit, then their final effective tax rate would be 7.52%.

If inflation averaged 3% per annum over the period 2002 to 2010, then a $80,000 income in 2002 would equate to a $101,342 income in 2010. The tax reductions in EGTRRA would reduce this family's pre-tax credit effective income tax rate to 9.11% in 2010. Hence, their pre-credit regular income tax would fall from 10.52% in 2002 to 9.11% in 2010.

However, in 2010, this family's pre-tax credit effective AMT rate would be 14.45%. Since their AMT liability is higher than their regular income tax liability the family would pay the AMT. If the family received four child tax credits at $1,000 per credit, then their final effective tax rate would be 10.50%.

Hence, not only does the AMT "take back" all of the EGTRRA tax reductions, the family will actually have a higher tax burden in 2010 than they did in 2002.

In addition, any future reductions in the federal income tax burden without modifications to the AMT will likely increase the number of taxpayers subject to the AMT or subject to AMT limitations on their personal tax credits. For example, proposals to stimulate the economy through reductions in the individual income tax would likely push more taxpayers into the AMT.

The fact that the AMT is going to affect many upper middle income taxpayers and taxpayers with large families who were not subject to the tax in the past has prompted calls in Congress to remedy the situation. However, any changes to fix the AMT would be costly in terms of forgone revenue. For example, outright repeal of the AMT is estimated to cost $600 billion over the 2002-2010 period. Other solutions such as indexation of the AMT could cost as much as $370 billion over the next 10 years. If, in addition to indexation, the basic AMT exemption were increased or other changes were made to the AMT, then the revenue loss would be considerably larger.

From an economic perspective, the alternative minimum tax poses a dilemma. Under an income tax system designed to be consistent with economic theory, there would be no need for an alternative minimum tax. An economically ideal income tax would correctly measure real income and expense and then assess tax on a taxpayer's real net income. In these circumstances, where there is no erosion in the tax base, there would be no need for an alternative minimum tax. All taxpayers would already be paying what legislators have determined is their "fair share" of taxes as assessed by the regular income tax.

Given this, economic theory suggests that efforts might be better made to reform the regular income tax so as to bring it more in line with an economically ideal income tax. Then the alternative minimum tax could be eliminated.

It is unlikely, however, that the tax base of the regular individual income will be broadened to the point where there would be no place for an alternative minimum tax. If, in this environment, Congress wants to preserve all of the social and economic incentives in the tax code while still maintaining the concept that everyone should pay at least a minimum level of income tax and wants to limit the number of taxpayers subject to the AMT, then it will have to modify the tax. Modifying the system basically involves two issues: inflation and AMT coverage.

It has been suggested that the most important change that could be made would be to index the structural components of the alternative minimum tax for inflation. This would allow a consistent separation of the two tax systems to be maintained over time. It would also substantially reduce the number of taxpayers projected to be affected by the AMT in the future.

The second issue concerns the coverage of the AMT. Originally, the AMT was intended to cover only high-income taxpayers. This end of the income spectrum was where the use of tax incentives and preferences had produced the greatest deviation in income tax payments, allowing some taxpayers to significantly lower their income taxes.

Recent changes to the tax code, however, have markedly increased the availability of special tax incentives and preferences to taxpayers in the middle and upper-middle range of the income spectrum. This will produce substantial reductions in the income tax liabilities of those taxpayers who have the ability or find themselves in the right circumstances to take advantage of the tax preferences. This is likely to produce large deviations in the income tax liabilities of otherwise similarly situated taxpayers in the middle and upper-middle income ranges.

To minimize these deviations and satisfy the AMT rationale that everyone pays at least a minimum of income taxes, it has been suggested that for consistency, the AMT should also be applied across the middle- and upper-middle portion of the income spectrum. The AMT would then be adjusted to reflect coverage of this portion of the income spectrum. While this approach would add to the complexity of the current system and would mean that some middle and upper-middle income taxpayers may not see the full benefits of some recently enacted tax breaks, it would help maintain some consistency in AMT approach across the income spectrum.

Legislative Initiatives in the 106th Congress

The Financial Freedom Act of 1999 was passed by the House on July 22, 1999. It would have phased out the individual AMT with full repeal effective by tax year 2009. In addition, during the phase out period it would have allowed nonrefundable tax credits to fully offset AMT tax liability. The JCT estimated that these changes would have cost $63.6 billion through fiscal year 2009.

The Taxpayer Refund Act of 1999 was passed by the Senate in late July and would have allowed taxpayers to offset their entire regular income tax liability by the amount of their nonrefundable personal credits without regard to the AMT. In addition, it would have repealed the provision reducing refundable child care tax credit by the AMT. These two provisions would have been effective beginning in tax year 1999. The Taxpayer Refund Act of 1999 would have also allowed personal exemptions to be deducted for purposes of calculating AMT tax liability, with this provision taking effect in tax year 2005. The JCT estimated that these changes would have cost $96 billion through fiscal year 2009.

The Conference Agreement (H.R. 2488) that was approved by both the House and the Senate on August 5, 1999 adopted the House proposal for changes in the AMT. The Conference Agreement would have allowed individuals to offset their entire regular tax liability (without regard to their AMT) by the amount of their personal nonrefundable tax credits. The Agreement would have also repealed the current law provision limiting the refundable portion of the child credit by the taxpayer's AMT. Finally, it would have phased out the AMT starting in 2005 with full AMT repeal starting in 2008.

On September 23, 1999, however, H.R. 2488 was vetoed by President Clinton.

In response to the veto of their major tax cut legislation, both the House and the Senate produced more targeted bills that would extend several expiring tax provisions. The final compromise bill (H.R. 1180) extending these expiring tax provisions was approved by the House on November 18 and by the Senate on November 19. As part of this bill, the existing tax provision, that allows individuals to offset their regular income tax by the full amount of their nonrefundable personal tax credits regardless of the AMT, was extended through December 31, 2001.

In mid July 2000, both the House and the Senate passed the Marriage Tax Penalty Relief Reconciliation Act of 2000 (H.R. 4810). One of the provisions of this

Act would have permanently allowed the personal nonrefundable and refundable tax credits to offset both an individual's regular and alternative minimum income tax. Citing concerns over the revenue and distributional consequences of this legislation, however, President Clinton vetoed the bill on August 5, 2000.

Legislative Initiatives in the 107th Congress

As part of his original tax cut plan in the spring of 2001, President Bush proposed increasing the child tax credit from $500 to $1,000. In addition, he proposed making permanent the temporary rule in current law that allows the child tax credit to offset a taxpayer's alternative minimum tax (AMT).

The Economic Growth and Tax Relief Reconciliation Act of 2001 (H.R. 1836) was approved by both chambers of Congress on May 26, 2001 and signed by President George W. Bush on June 7, 2001 (P.L. 107-16). This Act permanently allowed the child tax credit, the adoption tax credit, and the IRA contribution tax credit to be claimed to the extent of the full amount of a taxpayer's regular income tax and alternative minimum tax. The Act also temporarily increased the AMT exemption amount by $4,000 for joint returns ($2,000 for unmarried individuals) effective for tax years between 2001 and 2004. In tax year 2005, the AMT exemption amount reverts back to its previous levels.

On March 9, 2002, President Bush signed the Job Creation and Worker Assistance Act of 2002 (P.L. 107-147). This Act extends the temporary provisions, first enacted in 1998, that allow individuals to use all personal tax credits against both their regular and AMT tax liabilities. This change is effective through December 31, 2003.