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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The alternative minimum tax for individuals (AMT) was originally enacted to ensure that high-income taxpayers paid a fair share of the federal income tax.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 this tax.

Temporary increases in the AMT exemption are scheduled to expire at the end of 2005. If this occurs, then 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The alternative minimum tax (AMT) for individuals was originally enacted to ensure that all taxpayers, especially high-income taxpayers, paid at least a minimum amount of federal taxes.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 2004, about 3 million taxpayers were subject to the AMT, but by 2006, up to 21 million taxpayers could be subject to the AMT.

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.[1]

The effects of the AMT have been temporarily mitigated through an increase in the basic exemption for the AMT. For 2005, the AMT exemption is $58,000 for joint returns and $40,250 for unmarried taxpayers. In 2006, the basic AMT exemption is scheduled to decrease to its prior law levels of $45,000 for joint returns and $35,750 for unmarried taxpayers.

Who Will be Subject to the AMT in the Future?

If, in 2006, the basic exemption for the AMT reverts to its lower prior-law levels then not only will there be a significant increase in the number of taxpayers subject to the AMT, 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.

- 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.[2] Taxpayers in high-tax states who claim

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[1] For more detailed information on the AMT see CRS Report RL30149, *The Alternative Minimum Tax for Individuals*, by Gregg Esenwein.

[2] 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

(continued...)

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, the District of Columbia, and California will tend to be more adversely affected by the AMT than will taxpayers in low-tax states such as Tennessee, South Dakota, Alaska, Alabama, and Mississippi.[3]

- In 2006, 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 $67,500. Taxpayers filing joint returns with no children (two personal exemptions) will be subject to the AMT when their incomes exceed $76,500.[4]

Table 1 shows the effects of the AMT by adjusted gross income (AGI) levels for 2005 through 2010.

- In 2005, taxpayers with AGIs in the $200,000 to $500,000 range are the most affected by the AMT. Almost 67% of taxpayers in this income range have AMT liabilities.

- In 2006 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 95% of the taxpayers with AGIs of $100,000 to $200,000 will be subject to the AMT. Almost 86% of taxpayers with AGIs in the $200,000 to $500,000 range will be subject to the AMT.

- 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 2006 to 2010 period. By 2010, over 66% of the taxpayers in this income range will be subject to the AMT.

- The number of very high-income taxpayers (AGIs over $500,000) subject to the AMT will remain relatively constant over the 2005 through 2010 period.

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[2] (...continued)
that they exceed 10% of AGI .

[3] 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*, by Gregg Esenwein.

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

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 2005 Dollars Calendar Years 2005-2010

Adjusted Gross Income (000s)	2005	2006	2007	2008	2009	2010
Less than $50	0.0%	0.4%	0.8%	1.4%	2.2%	3.3%
$50 - $100	1.3%	34.6%	42.8%	50.5%	59.0%	65.9%
$100 - $200	16.7%	81.1%	86.2%	90.7%	93.0%	95.3%
$200 - $500	66.6%	86.9%	85.2%	86.5%	83.5%	85.7%
$500 - $1,000	27.5%	30.4%	28.4%	30.7%	28.4%	30.3%
Over $1,000	21.2%	23.4%	23.1%	24.9%	23.8%	25.5%
All taxpayers	2.1%	11.6%	13.2%	14.7%	16.3%	17.9%

Source: Congressional Budget Office.

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. Hence, many high-income taxpayers do not get a basic exemption under the AMT. Therefore, the scheduled 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%.