OVERVIEW OF PRESENT LAW AND ECONOMIC ANALYSIS RELATING TO THE MARRIAGE TAX PENALTY, THE CHILD TAX CREDIT, AND THE ALTERNATIVE MINIMUM TAX

Scheduled for a Public Hearing

Before the

SENATE COMMITTEE ON FINANCE

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INTRODUCTION

The Senate Committee on Finance has scheduled a public hearing on Thursday, March 8, 2001, on "Easing the Family Tax Burden." The hearing will address proposals of President Bush relating to the child tax credit, the marriage tax penalty, and the alternative minimum tax. This document,[1] prepared by the staff of the Joint Committee on Taxation, provides a description of present law and background relating to the marriage tax penalty (Part I), the child tax credit (Part II) and the individual alternative minimum tax (Part III). A brief analysis section is also included for each part.

[1] This document may be cited as follows: Joint Committee on Taxation, *Overview of Present Law and Economic Analysis Relating to the Marriage Tax Penalty, the Child Tax Credit, and the Alternative Minimum Tax* (JCX-8-01), March 7, 2001.

I. MARRIAGE TAX PENALTY

A. Present Law and Legislative Background

Present Law

In general

A marriage penalty exists when the sum of the tax liabilities of two unmarried individuals filing their own tax returns (either single or head of household returns) is less than their tax liability under a joint return (if the two individuals were to marry). A marriage bonus exists when the sum of the tax liabilities of the individuals is greater than their combined tax liability under a joint return.

While the size of any marriage penalty or bonus under present law depends upon the individuals' incomes, number of dependents, and itemized deductions, as a general rule married couples whose earnings are split more evenly than 70-30 suffer a marriage penalty. Married couples whose earnings are largely attributable to one spouse generally receive a marriage bonus. Although the marginal tax rate breakpoints[2] and the standard deduction are typically considered the major elements of the Federal income tax system that create marriage penalties and bonuses, other provisions of present law also contribute to the amount of marriage penalty or bonus any couple will face.

Marriage penalties due to rate brackets and the standard deduction

Under present law, the size of the standard deduction and the bracket breakpoints follow certain customary ratios across filing statuses. For taxpayers in the 15-, 28-, and 31-percent marginal tax rate brackets, the bracket breakpoints and the standard deduction for single filers are roughly 60 percent of those for joint filers and those for head of household filers are about 85 percent of those for joint filers. For the 36-percent bracket, the breakpoints for single filers and for head of household filers are 82 percent and 91 percent, respectively, of the breakpoint for joint filers. For the 39.6-percent bracket, the bracket breakpoint is $297,350 (for 2001) regardless of filing status.

With these ratios, the sum of the standard deductions two unmarried individuals would receive exceeds the standard deduction they would receive as a married couple filing a joint return. Thus, their taxable income as joint filers may exceed the sum of their taxable incomes as unmarried individuals. Furthermore, because of the way the bracket breakpoints are structured, taxpayers filing joint returns may have more of their taxable income pushed into a higher marginal tax bracket than when they were unmarried. In order for there to be no marriage penalties as a result of the rate structure and the standard deduction, the standard deduction and the bracket breakpoints for married taxpayers filing joint returns would have to be at least twice that for both single and head of household filers. Such a structure would greatly enhance marriage bonuses, however.

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[2] A bracket breakpoint is the dividing point between two marginal rate brackets.

Marriage penalties and bonuses due to income-based phaseins and phaseouts

Marriage penalties or bonuses also will arise whenever a tax provision exists that has an income-based phase-in or phase-out provision. For any such provision, whether a marriage penalty or a marriage bonus arises will depend on the circumstances of the particular taxpayers and on the income levels at which the phase-out ranges occur for single or head of household taxpayers versus married taxpayers filing jointly. While setting the bracket breakpoints for married taxpayers filing jointly at twice that for singles and head of households would eliminate marriage penalties arising from the rate structure, no such remedy is available with respect to phaseins or phaseouts of tax provisions, even if the phaseout ranges were double that of singles or heads of households. The reason for this is that a single taxpayer who qualifies for a particular tax benefit will no longer qualify if he or she marries and the combined income of the couple exceeds the level for married taxpayers filing joint returns to qualify for the benefit. This could happen regardless of where the phase-out ranges are set for married taxpayers filing joint returns, as long as one spouse had sufficient income to put the combined return over the income limits to qualify for the benefit. This situation is most likely to occur when one spouse has relatively high income, and thus the marriage penalty from the phaseout provision may be offset by a marriage bonus resulting from the rate structure and unequal distribution of income across spouses.

There are many examples of phaseouts and phaseins of tax provisions in the current Federal income tax laws that cause marriage penalties and bonuses.[3] For example, the provision of present law that requires a portion of social security benefits to be included in income can create either a marriage penalty (because it is possible that one spouse's taxable income may require the other spouse's social security benefits to be included in income) or a marriage bonus (because spouses with relatively unequal incomes may have less total social security benefits included in income than if the spouses were not married).

Marriage penalties for low-income individuals

There are three features of the current Federal individual income tax system that can create a marriage penalty for low-income individuals: the variation of the size of the standard deduction by filing status; the phaseout of the earned income credit ("EIC") as income increases; and the variation of the size of the EIC by the number of qualifying children.

As discussed above, when two unmarried individuals marry, their standard deduction as a married couple is less than the sum of their standard deductions as single taxpayers. For those that take the standard deduction rather than itemize, this produces a marriage penalty because the lower standard deduction means taxable income is correspondingly higher. Because lower income taxpayers are more likely to use the standard deduction, this feature of present law is a

[3] For a complete discussion of various phase-in and phase-out rules, see Joint Committee on Taxation, *Present Law and Analysis Relating to Individual Effective Marginal Tax Rates* (JCS -3-98), February 3, 1998.

more important part of the marriage penalty for lower-income taxpayers relative to higher-income taxpayers.

In addition to the potential for marriage penalties in the rate structure and standard deduction, the structure of the EIC may create marriage penalties. Because the EIC increases over one range of income and then is phased out over another range of income, the aggregation of incomes that occurs when two individuals marry may reduce the amount of EIC for which they are eligible.[4] This problem is particularly acute because the EIC does not feature a higher phaseout range for married taxpayers than for heads of households.

Marriage may reduce the size of a couple's EIC not only because their incomes are aggregated, but also because the number of qualifying children is aggregated. Because the amount of EIC does not increase when a taxpayer has more than two qualifying children, marriages that result in families of more than two qualifying children will provide a smaller EIC per child than when their parents were unmarried. Even when each unmarried individual brings just one qualifying child into the marriage there is a reduction in the amount of EIC per child, because the maximum credit for two children is generally less than twice the maximum credit for one child.

These three features can cause unmarried individuals who are eligible for the EIC to face significant marriage penalties. For example, in 2001, two individuals, each with one qualifying child and wage income of $15,000, would face a marriage penalty of $4,417[5] due largely to the EIC.[6]

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[4] In the case of two individuals with very low wage income, marriage may increase the amount of the EIC available with respect to a qualifying child. If the individual with the qualifying child is in the phase-in range of the EIC, the aggregation of incomes upon marriage could increase the amount of the EIC.

[5] An individual with $15,000 in wage income and one child would have a regular tax liability of $383 before credits. The $500 nonrefundable child credit would reduce this liability to $0, and the remainder of the credit would go unused because it is a nonrefundable credit. Additionally, an EIC of $2,122 would be allowed, for a net Federal tax liability of -$2,122. If this individual marries another individual in the same circumstances (i.e., one with the same income and one child, and thus the same tax liability) their regular Federal income tax liability would be $1,620 on their combined income of $30,000, and thus they would be eligible for the full child credit of $1,000 for the two children. Additionally, they would receive an EIC of $447, for a net Federal income tax liability of $173. The marriage penalty is thus $173 - (-$2,122 + -$2,122) = $4,417.

[6] The amount of the marriage penalty would have been even larger if each individual had two or more children, for the reasons discussed in the text. This would be mitigated only somewhat by the fact that the resulting family would have three or more children and thus be entitled to a refundable child credit.

Legislative Background

The marriage penalty in the current income tax rate structure dates from changes in the structure of individual income tax rates in 1969.[7] To understand the effect of those changes, one needs to go back to 1948, when separate rate schedules for married couples filing joint returns and single taxpayers were introduced.

Before 1948, there was only one income tax schedule, and all individuals were liable for tax as separate filing units. Under this tax structure, there was neither a marriage penalty nor a marriage bonus. However, this structure created an incentive to split incomes because, with a progressive income tax rate structure, a married couple with only one spouse earning income could reduce their combined tax liability if they could split their income and assign half to each spouse. While the Supreme Court upheld the denial of contractual attempts to split income,[8] it ruled that in States with community property laws, income splitting was required for community income.[9] As income tax rates and the number of individuals liable for income taxes increased before and during World War II, States had an increasing incentive to adopt community property statutes to give their citizens the tax benefits of income splitting.

The Revenue Act of 1948 provided the benefit of income splitting to all married couples by establishing a separate tax schedule for married couples filing joint returns. That schedule was designed so that married couples would pay twice the tax of a single taxpayer having one-half the couple's taxable income.[10] While this new schedule equalized treatment between married couples in States with community property laws and those in States with separate property laws, it introduced a marriage bonus into the tax law for couples in States with separate property laws.[11] As a result of this basic rate structure, by 1969, an individual with the same income as a married couple could have had a tax liability as much as 40 percent higher than that of the married couple. To address this perceived inequity, which was labeled a "singles penalty" by some commentators, a special rate schedule was introduced for single taxpayers (leaving the old schedule solely for married individuals filing separate returns). The bracket breakpoints and standard deduction amounts for single taxpayers were set at about 60 percent of those for married couples filing joint returns. This schedule created a marriage penalty for some taxpayers.

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[7] In 1951, a separate rate schedule was created for unmarried heads of household with dependents ("head of household" status). Because the bracket breakpoints and standard deduction were more than half of those for joint returns, marriage penalties arose for some taxpayers eligible for filing as head of household.

[8] *Lucas v. Earl,* 281 U.S. 111 (1930).

[9] *Poe v. Seaborn,* 282 U.S. 101 (1930).

[10] This relationship between rate schedules is the same as that between joint returns and separate returns for married couples under present law.

[11] Because income splitting had been available in community property States prior to 1948, a marriage bonus had already existed in such States.

In 1981, Congress created a deduction for two-earner married couples. The maximum deduction equaled 10 percent of the lesser of: (1) the earned income of the spouse with lower income or (2) $30,000. The two-earner deduction, was, in part, created to alleviate the work disincentive effects of high marginal tax rates on the second earner's income. The Tax Reform Act of 1986 repealed the two-earner deduction in conjunction with the enactment of generally lower tax rates.

B. Analysis

Data relating to marriage penalty under present law

There is no precisely accurate measure of the size of the marriage penalty or bonus under present law. The amount of penalty or bonus that any married couple will face depends on the particular characteristics of the couple's income, deductions, credits, etc., and how such items of income, etc., are assumed to be divided between the spouses.

Under Congressional Budget Office ("CBO") calculations prepared in 1998, the marriage penalty estimated for 1999 under their basic set of assumptions was estimated to be $32.2 billion for 21.7 million returns, and the marriage bonus was estimated to be $42.5 billion for 26.3 million returns. Under this set of assumptions, the 21.7 million returns with a marriage penalty had an average penalty of $1,480 and the 26.3 million returns with a marriage bonus had an average bonus of $1,600.[12]

Marriage neutrality versus equal taxation of married couples with equal incomes

Any system of taxing married couples requires making a choice among three different concepts of tax equity. One concept is that the tax system should be "marriage neutral;" that is, the tax burden of a married couple should be exactly equal to the combined tax burden of two single persons where one has the same income as the husband and the other has the same income as the wife. A second concept of equity is that, because married couples frequently consume as a unit, couples with the same income should pay the same amount of tax regardless of how the income is divided between them. (This second concept of equity could apply equally well to other tax units that may consume jointly, such as the extended family or the household, defined as all people living together under one roof.) A third concept of equity is that the income tax should be progressive; that is, as income rises, the tax burden should rise as a percentage of income.

These three concepts of equity are mutually inconsistent. A tax system can generally satisfy any two of them, but not all three. The current tax system is progressive: as a taxpayer's

[12] The basic assumptions assume that spouses divide unearned income and itemized deductions in proportion to their earnings. The first child is assigned to the spouse with higher earnings, the second child to the lower-earning spouse, and all others to the higher earner. If eligible, both spouses can file as head of household and claim the EIC. The data presented here are updated estimates of the CBO study. For a complete discussion of the assumptions and analysis, see Congressional Budget Office, *For Better or for Worse: Marriage and the Federal Income Tax*, June 1997.

income rises, the tax burden increases as a percentage of income. It also taxes married couples with equal income equally: It specifies the married couple as the tax unit so that married couples with the same income pay the same tax. But it is not marriage neutral.[13] A system of mandatory separate filing for married couples would sacrifice the principle of equal taxation of married couples with equal incomes for the principle of marriage neutrality unless it were to forgo progressivity.[14]

There is disagreement as to whether equal taxation of couples with equal incomes is a better principle than marriage neutrality.[15] Those who hold marriage neutrality to be more important tend to focus on marriage penalties that may arise under present law and argue that tax policy discourages marriage and encourages unmarried individuals to cohabit without getting married, thereby lowering society's standard of morality. Also, they argue that it is simply unfair to impose a marriage penalty even if the penalty does not actually deter anyone from marrying.

Those who favor the principle of equal taxation of married couples with equal incomes argue that as long as most couples pool their income and consume as a unit, two married couples with $20,000 of income are equally well off regardless of whether their income is divided $10,000-$10,000 or $15,000-$5,000. Thus, it is argued, those two married couples should pay the same tax, as they do under present law. By contrast, a marriage-neutral system with progressive rates would involve a larger combined tax on the married couple with the unequal

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[13] Even if the bracket breakpoints and the standard deduction amounts for unmarried taxpayers (and for married taxpayers filing separate returns) were half of those for married couples filing a joint return, the current tax system would not be marriage neutral. Many married couples would still have marriage bonuses. As described below, the joint return in such a system would allow married couples to pay twice the tax of a single taxpayer having one-half the couple's taxable income. With progressive rates, this income splitting may result in reduced tax liabilities for some couples filing joint returns. For example, consider a married couple in which one spouse has $60,000 of income and the other has none. By filing a joint return, the couple pays the same tax as a pair of unmarried individuals each with $30,000 of income. With progressive taxation, the tax liability on $30,000 would be less than half of the tax liability on $60,000. Thus the married couple has a marriage bonus: the joint return results in a smaller tax liability than the combined tax liability of the spouses if they were not married.

[14] It should be noted that there is an exception to this rule if refundable credits are permissible. A system with a single tax rate and a per taxpayer refundable credit would have marriage neutrality, equal taxation of couples with equal incomes, and progressivity. In such a system, the refundability of the tax credit combined with an equal marginal tax rate on all income would make irrelevant any splitting of income between the individuals. Refundability of the tax credit also would create progressivity in what would otherwise be a proportional tax. Such a system could <u>not</u> have standard deductions.

[15] This discussion assumes that the dilemma cannot be resolved by moving to a proportional tax (i.e. a single rate on all income for all taxpayers) system. A proportional system would automatically produce marriage neutrality and equal taxation of couples with equal incomes.

income division. The attractiveness of the principle of equal taxation of couples with equal incomes may depend on the extent to which married couples actually pool their incomes.[16]

An advocate of marriage neutrality could respond that the relevant comparison is not between a two-earner married couple where the spouses have equal incomes and a two-earner married couple with an unequal income division, but rather between a two-earner married couple and a one-earner married couple with the same total income. Here, the case for equal taxation of the two couples may be weaker, because the non-earner in the one-earner married couple benefits from more time that may be used for unpaid work inside the home, other activities or leisure. It could, of course, be argued in response that the "leisure" of the non-earner may in fact consist of necessary job hunting or child care, in which case the one-earner married couple may not have more ability to pay income tax than the two-earner married couple with the same income.[17]

Marriage penalty, labor supply, and economic efficiency

Most analysts discuss the marriage penalty or marriage bonus as an issue of fairness, but the marriage penalty or bonus also may create economic inefficiencies. The marriage penalty or bonus may distort taxpayer behavior. The most obvious decision that may be distorted is the decision to marry. For taxpayers for whom the marriage penalty exists, the tax system increases the "price" of marriage. For taxpayers for whom the marriage bonus exists, the tax system reduces the "price" of marriage. Most of what is offered as evidence of distorted choice is anecdotal. There is no statistical evidence that the marriage penalty or marriage bonus has altered taxpayers' decisions to marry. Even if the marriage decision were distorted, it would be difficult to measure the cost to society of delayed or accelerated marriages or alternative family structures.

Some analysts have suggested that the marriage penalty may alter taxpayers' decisions to work. As explained above, a marriage penalty exists when the sum of the tax liabilities of two unmarried individuals filing their own tax returns (either single or head of household returns) is less than their tax liability under a joint return (if the two individuals were to marry). This is the result of a tax system with increasing marginal tax rates. The marriage penalty not only means the total tax liability of the two formerly single taxpayers is higher after marriage than before

[16] For some recent articles calling into question the justification for joint returns and the assumption of pooling of income among members of a household, *see* Marjorie E. Kornhauser, "Love, Money, and the IRS: Family, Income Sharing, and the Joint Income Tax Return," 45 *Hastings Law Journal* 63 (1993); Edward J. McCaffery, "Taxation and the Family: A Fresh Look at Behavioral Gender Biases in the Code," 40 *UCLA Law Rev*iew 983 (1993); and Lawrence Zelenak, "Marriage and the Income Tax," 67 *Southern California Law Review* 399 (1994).

[17] If the two-earner couple had child care expenses many would think that the single-earner couple of with children and the same income would have a greater ability to pay taxes as the family would benefit from the unpaid labor of the stay-at-home spouse with regard to child care.

marriage, but it also generally may result in one or both of the formerly single taxpayers being in a higher marginal tax rate bracket. That is, the additional tax on an additional dollar of income of each taxpayer is greater after marriage than it was when they were both single. Economists argue that changes in marginal tax rates may affect taxpayers' decisions to work. Higher marginal tax rates may discourage household saving and labor supply by the newly married household. For example, suppose a woman currently in the 28-percent tax bracket marries a man who currently is unemployed. If they had remained single and the man became employed, the first $7,450 of his earnings would be tax-free.[18] However, because he marries a woman in the 28-percent income tax bracket, if he becomes employed he would have a tax liability of 28 cents on his first dollar of earnings, leaving a net of 72 cents for his labor.[19] Filing a joint return may distort the man's decision regarding whether to enter the work force. If he chooses not to work, society loses the benefit of his labor. Some have suggested that the labor supply decision of the lower earner or "secondary earner" in married households may be quite sensitive to the household's marginal tax rate.[20]

The possible disincentive effects of a higher marginal tax rate on the secondary worker arise in the case of couples who experience a marriage bonus as well. In the specific example above, the couple consisted of one person in the labor force and one person not in the labor force. As noted previously, such a circumstance generally results in a marriage bonus. By filing a joint return, the lower earner may become subject to the marginal tax rate of the higher earner. By creating higher marginal tax rates on secondary earners, joint filing may discourage a number of individuals from entering the work force or it may discourage those already in the labor force from working additional hours.[21]

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[18] As a single taxpayer, the man could claim the standard deduction of $4,550 and one personal exemption of $2,900 for 2001, effectively exempting the first $7,450 of his earnings. This example ignores payroll taxes.

[19] This example assumes that as a result of the marriage the combined income is still high enough to place the couple in the 28 percent bracket with respect to the rate schedule for married taxpayers filing jointly. It is possible that if the woman were just into the 28-percent bracket as a single filer the combined income of the couple would place them in the 15-percent bracket for married couples. In this case the marginal tax rate with respect to the income tax for the man would have increased from 0 to 15 percent, while that of the woman would have fallen from 28 percent to 15 percent.

[20] See Charles L. Ballard, John B. Shoven, and John Whalley, "General Equilibrium Computations of the Marginal Welfare Costs of Taxes in the United States," *American Economic Review*, 75, March 1985, for a review of econometric studies on labor supply of so-called primary and secondary earners. CBO, *For Better or Worse*, pp. 10-12, also reviews this literature.

[21] The decision to work additional hours may be less sensitive to changes in the marginal tax rate than the decision to enter the labor force. See, Robert K. Triest, "The Effect of Income Taxation on Labor Supply in the United States," *Journal of Human Resources*, 25, 1990.

Eliminating or reducing the marriage penalty

The marriage penalty with respect to the rate structure could be eliminated in two ways. One is through restructuring of rates (across different filing statuses). The other is by giving married couples the option to calculate their tax liability as if they were unmarried.

To eliminate the marriage penalty through a change in the rate structure, the brackets for all unmarried taxpayers (both singles and heads of household) would have to be half as large as the married, filing joint brackets. This change could either gain or lose revenue--depending on whether unmarried individuals have their rate brackets shifted down or joint filers have theirs shifted up.[22] This change would exacerbate existing marriage bonuses if the rate schedule for married taxpayers filing jointly were increased. Regardless of the manner in which the rates were adjusted (i.e., by increasing bracket breakpoints for married taxpayers or reducing them for singles and heads of households), a structure with rates for married taxpayers at twice the level of single and heads of households would cause marriage bonuses. Another effect of such a step would be that single individuals and heads of household with identical incomes would find their tax liabilities nearly the same (they would differ only because of extra personal exemptions for the head of household's dependents and any EIC). Relying solely on extra personal exemptions to adjust for family size would result in unmarried individuals with dependents receiving smaller tax benefits than they now receive by filing as head of household (assuming that the head of household rate is adjusted downward to match the singles rate, rather than the reverse). Such a change in rate structure also would bring back the "singles penalty" that led to the creation of an unmarried filing status (separate from married, filing separately) in 1969.

Allowing joint filers the option of calculating a combined tax liability as if they were not married would eliminate the problem of the marriage penalty at the cost of complicating the tax return. While eliminating marriage penalties, it would preserve all marriage bonuses. To take advantage of the provision, taxpayers would have to calculate their tax liability under two alternatives and then choose the smaller liability. Rules would have to prescribe how taxpayers would allocate deductions, dependent exemptions, and unearned income (if any) between the two spouses or the spouses could be allowed to allocate them in the most favorable manner. In many cases, it would be difficult for the Internal Revenue Service to enforce detailed rules short of audit; in practice, taxpayers could have wide latitude to allocate deductions and unearned income in the most favorable way.[23]

A second issue for the optional unmarried filing is what filing status to allow taxpayers with dependents to use. Married filers with dependents could be allowed to file as heads of household or permitted only to file as a single taxpayer. If one measures the marriage penalty

[22] A revenue neutral result could be fashioned by the appropriate combination of increases in the breakpoints for married taxpayers and decreases in those for singles and heads of households.

[23] For example, the Virginia State income tax allows separate reporting of income by married couples on a combined tax return, with separate allocations of personal exemptions and deductions as determined by the taxpayer.

relative to what tax treatment the spouses would get if they divorced, then head of household filing may be appropriate, at least for one spouse. If the spouses did actually divorce, head of household status would generally be available to both of the former spouses only if each had at least one dependent living with them. If one measures the marriage penalty relative to the tax treatment before the time of marriage, then the answer hinges upon whether the dependents arose before or after the marriage.

An alternative approach would be to reduce the marriage penalty by returning to the 1982-1986 second-earner deduction, which allowed joint filers a deduction for 10 percent of the lesser of the earned income of the lower-earning spouse or $30,000. This approach reduces the marginal tax rate on the lower-earning spouse, but does not eliminate the marriage penalty, especially if the size of the deduction is capped, as was the 1982-1986 deduction. While this approach is not tailored to the particular situation of a married couple, it is much easier to administer than calculating separate liabilities for each spouse. One advantage of the second-earner deduction approach is that the benefit of the deduction is more targeted to those taxpayers that actually face marriage penalties, while generally limiting increases in marriage bonuses.[24] The second-earner deduction would provide a tax benefit to some couples who already experience marriage bonuses (i.e., those couples where the earnings are split less evenly than 70/30 as previously discussed). However, the relative value of the deduction to those couples would be small because to be in the bonus situation the earnings of the lower-earning spouse are usually small.

[24] This follows because it is two-earner couples that generally have marriage penalties, while single earner couples, who would not benefit from the second-earner deduction, generally experience marriage bonuses. The two earner deduction would not affect marriage penalties that result from the EIC, and nor would changes to the general rate structure. Of the options considered here, only the separate filing option would impact marriage penalties that result from the EIC.

II. CHILD TAX CREDIT

A. Present Law

Child tax credit

Present law provides a $500 tax credit for each qualifying child under the age of 17. In general, the credit is nonrefundable for taxpayers with two or fewer children. However, for taxpayers with three or more qualifying children, a refundable child credit is provided up to the amount by which the liability for social security taxes exceeds the amount of the EIC (sec. 24(d)). For taxable years beginning after 2001, the refundable child credit is reduced by the amount of the individual's minimum tax liability. In general, a qualifying child is defined as an individual for whom the taxpayer can claim a dependency exemption and who is a son or daughter of the taxpayer (or a descendent of either), a stepson or stepdaughter of the taxpayer or an eligible foster child of the taxpayer. The amount of the otherwise allowable child credit that can be claimed by an individual may be affected by the operation of the alternative minimum tax, described below.

For taxpayers with modified adjusted gross income ("modified AGI") in excess of certain thresholds, the otherwise allowable child credit is phased out. Specifically, the otherwise allowable child credit is reduced by $50 for each $1,000 of modified AGI (or fraction thereof) in excess of the applicable threshold. Modified AGI is the sum of the taxpayer's AGI plus amounts excluded from gross income under Code sections 911, 931, or 933 (relating to the exclusion of income of U.S. citizens or residents living abroad; residents of Guam, American Samoa, and the Northern Mariana Islands; and residents of Puerto Rico, respectively). For married taxpayers filing joint returns, the threshold is $110,000. For taxpayers filing single or head of household returns, the threshold is $75,000. For married taxpayers filing separate returns, the threshold is $55,000. These thresholds are not indexed for inflation. The length of the phase-out range depends on the number of the taxpayer's qualifying children. For example, in 2001, the phase-out range for a single person with one qualifying child is between $75,000 and $85,000 of modified AGI. The phase-out range for a single person with two qualifying children is between $75,000 and $95,000 of modified AGI in 2001.

Alternative minimum tax

In general

An individual's tentative minimum tax is an amount equal to (1) 26 percent of the first $175,000 ($87,500 in the case of a married individual filing a separate return) of alternative minimum taxable income ("AMTI") in excess of a phased-out exemption amount and (2) 28 percent of the remaining AMTI. The maximum tax rates on net capital gain used in computing the tentative minimum tax are the same as under the regular tax. AMTI is the individual's taxable income adjusted to take account of specified preferences and adjustments. The exemption amounts are: (1) $45,000 in the case of married individuals filing a joint return and surviving spouses; (2) $33,750 in the case of other unmarried individuals; and (3) $22,500 in the case of married individuals filing a separate return, estates and trusts. The exemption amounts are phased out by an amount equal to 25 percent of the amount by which the individual's AMTI

exceeds (1) $150,000 in the case of married individuals filing a joint return and surviving spouses, (2) $112,500 in the case of other unmarried individuals, and (3) $75,000 in the case of married individuals filing separate returns or an estate or a trust. These amounts are not indexed for inflation.

Personal nonrefundable credits

Through 2001, an individual generally may reduce his or her tentative AMT liability by nonrefundable personal tax credits including the child credit and certain other credits such as the HOPE and Lifetime Learning credits. For taxable years beginning after December 31, 2001, these nonrefundable credits are allowed only to the extent that the individual's regular income tax liability exceeds the individual's tentative minimum tax, determined without regard to the minimum tax foreign tax credit. For taxable years beginning during 2000 and 2001, these credits are allowed to the extent of the full amount of the individual's regular tax and alternative minimum tax.

Refundable credits

For families with three or more qualifying children, a refundable child credit is provided, up to the amount by which the liability for social security taxes exceeds the amount of the earned income credit (sec. 24(d)). In addition, a refundable earned income credit is provided for individuals with earned income below certain amounts. The earned income credit and, for taxable years beginning after 2001, the refundable child credit are reduced by the amount of the individual's minimum tax liability.

B. Analysis

In general

One of the basic tenets of tax policy is that an accurate measurement of ability to pay taxes is essential to tax fairness. Some criticize the present law child credit as too small because the current maximum amount of the credit does not adequately reflect the cost of raising a child. Proponents of an expansion of the size of the child credit argue that $500 is inadequate, even if taken together with the personal exemption available for each qualifying child. They argue that the credit should be increased to better reflect the reduced ability to pay of taxpayers with children. Others argue that the full financial cost of raising a child should not be presumed to be a public responsibility, and that the child credit and dependent exemptions are not designed to fully offset costs of raising a child.

Personal nonrefundable credits

For taxable years beginning after December 31, 2001, the child credit and the other nonrefundable personal credits are allowed only to the extent the individual's regular tax liability exceeds the individual's tentative minimum tax liability, determined without regard to the minimum tax credit. The rapidly expanding number of taxpayers (including middle-income taxpayers) who will experience a reduction in their child credit and other nonrefundable credits in the next few years as a consequence of the AMT is viewed as a significant source of

complexity in the Code.[25] It also raises the issue whether the absence of indexing provisions in the individual alternative minimum tax has inadvertently expanded the alternative minimum tax to an increasing number of taxpayers. A more complete discussion of the individual alternative minimum tax is included in Part III, below.

Refundable credits

The child tax credit is refundable only for taxpayers with three or more qualified children. Some commentators argue that extending refundability to all taxpayers regardless of the number of qualifying children would result in more uniform treatment of taxpayers with qualifying children. Finally, they argue that making the child credit refundable regardless of the number of qualifying children will help deliver the benefits of the child credit to taxpayers who have inadequate income tax liability to utilize the credit but are liable for other Federal taxes (e.g., payroll taxes). Proposals to enhance the ability of taxpayers to utilize the full value of the child credit could be fashioned in several ways. One option would be to allow the child credit against regular and alternative minimum tax liability. Such a proposal might also entail a review of the present-law provision that reduces the child credit and the earned income credit by the amounts of the individual's alternative minimum tax. Another option would be to make the child credit fully refundable. Some may argue that this would be the equivalent of creating a means tested grant program administered by the Internal Revenue Service rather than another administrative agency.

[25] See table 5-7 in Part III.

The following table shows a distribution of the child tax credit by income class.

Table 1--Distribution of the Child Tax Credit, 2001

Income category[(1)]	Taxpayers claiming child credit (millions)	Child credit (Billions $)
Less than $10,000…..…….	0.1	(2)
10,000 to 20,000……..……...	1.5	$0.5
20,000 to 30,000……	3.7	2.0
30,000 to 40,000……	3.5	2.7
40,000 to 50,000……	3.2	2.6
50,000 to 75,000……	6.1	5.3
75,000 to 100,000……..	4.4	4.0
100,000 to 200,000……	3.3	2.7
200,000 and over……...	---	---
Total, all taxpayers…….	**25.8**	**$19.8**

Source: Joint Committee on Taxation
Detail may not add to total due to rounding.

(1) The income concept used to place tax returns into income categories is adjusted gross income plus [1] tax exempt interest, [2] employer contributions for health plans and life insurance, [3] employer share of FICA tax, [4] workers compensation, [5] nontaxable social security benefits, [6] insurance value of Medicare benefits, [7] alternative minimum tax preference items, and [8] excluded income of U.S. citizens living abroad. Categories are measured at 2001 levels.
(2) less than $50 million.

III. INDIVIDUAL ALTERNATIVE MINIMUM TAX

A. Present Law and Legislative Background

In general

Present law imposes an alternative minimum tax ("AMT") on an individual to the extent the taxpayer's tentative minimum tax liability exceeds his or her regular tax liability. The tentative minimum tax liability is computed for individuals at rates of (1) 26 percent on the first $175,000 of alternative minimum taxable income in excess of a phased-out exemption amount and (2) 28 percent on the amount in excess of $175,000. The exemption amounts are $45,000 in the case of married individuals filing a joint return and surviving spouses; $33,750 in the case of other unmarried individuals; and $22,500 in the case of married individuals filing a separate return, estates, and trusts. These exemption amounts are phased out by an amount equal to 25 percent of the amount that the individual's alternative minimum taxable income exceeds a threshold amount. These threshold amounts are $150,000 in the case of married individuals filing a joint return and surviving spouses; $112,500 in the case of other unmarried individuals; and $75,000 in the case of married individuals filing a separate return, estates, and trusts. The exemption amounts, the threshold phase-out amounts, and the $175,000 break-point amount are not indexed for inflation. The lower capital gains rates applicable to the regular tax also apply for purposes of the AMT.

Alternative minimum taxable income ("AMTI") is the taxpayer's taxable income increased by certain preference items and adjusted by determining the tax treatment of certain items in a manner that negates the deferral of income resulting from the regular tax treatment of those items.

With certain exceptions discussed below, nonrefundable credits may not reduce an individual's tax liability to less than the tentative minimum tax liability.

Preference items in computing AMTI

The minimum tax preference items are:

(1) The excess of the deduction for percentage depletion over the adjusted basis of mineral property at the end of the taxable year. This preference does not apply to percentage depletion allowed with respect to oil and gas properties.

(2) The amount by which excess intangible drilling costs arising in the taxable year exceed 65 percent of the net income from oil, gas, and geothermal properties. This preference does not apply to independent producers to the extent the producer's AMTI is reduced by 40 percent or less by ignoring the preference.

(3) Tax-exempt interest income on private activity bonds (other than qualified 501(c)(3) bonds) issued after August 7, 1986.

(4) Accelerated depreciation or amortization on certain property placed in service before January 1, 1987.

(5) Forty-two percent of the amount excluded from income under section 1202 (relating to gains on the sale of certain small business stock.)

In addition, losses from any tax shelter farm activity or passive activities are not taken into account in computing AMTI.[26]

Adjustments in computing AMTI

The adjustments that individuals must make to compute AMTI are:

(1) Depreciation on property placed in service after 1986 and before January 1, 1999, must be computed by using the generally longer class lives prescribed by the alternative depreciation system of section 168(g) and either (a) the straight-line method in the case of property subject to the straight-line method under the regular tax or (b) the 150-percent declining balance method in the case of other property. Depreciation on property placed in service after December 31, 1998, is computed by using the regular tax recovery periods and the AMT methods described in the previous sentence.

(2) Mining exploration and development costs must be capitalized and amortized over a 10-year period.

(3) Taxable income from a long-term contract (other than a home construction contract) must be computed using the percentage of completion method of accounting.

(4) The amortization deduction allowed for pollution control facilities placed in service before January 1, 1999 (generally determined using 60-month amortization for a portion of the cost of the facility under the regular tax), must be calculated under the alternative depreciation system (generally, using longer class lives and the straight-line method). The amortization deduction allowed for pollution control facilities placed in service after December 31, 1998, is calculated using the regular tax recovery periods and the straight-line method.

(5) Miscellaneous itemized deductions are not allowed.

(6) Deductions for State, local, and foreign real property taxes; State and local personal property taxes; and State, local, and foreign income, war profits, and excess profits taxes are not allowed.

(7) Medical expenses are allowed only to the extent they exceed ten percent of the taxpayer's adjusted gross income.

(8) Standard deductions and personal exemptions are not allowed.

[26] Given the passage of section 469 by the Tax Reform Act of 1986 (relating to the deductibility of losses from passive activities), these provisions are largely deadwood.

(9) The amount allowable as a deduction for circulation expenditures must be capitalized and amortized over a three-year period.

(10) The amount allowable as a deduction for research and experimentation expenditures must be capitalized and amortized over a 10-year period.[27]

(11) The special regular tax rules relating to incentive stock options do not apply.

Other rules

The combination of the taxpayer's net operating loss carryover and foreign tax credits cannot reduce the taxpayer's AMT liability by more than 90 percent of the amount determined without these items.

The various nonrefundable tax credits generally may not reduce the individual's regular tax liability below the tentative minimum tax. However, for taxable years beginning in 2000 and 2001 the nonrefundable personal credits (i.e., the dependent care credit, the credit for the elderly and disabled, the adoption credit, the child tax credit, the credit for interest on certain mortgages, the HOPE Scholarship and Lifetime Learning credit, and the D.C. homebuyer's credit) may offset both the regular tax and the AMT. The earned income credit and the additional child credit for taxpayers with three or more qualified children are refundable and thus are not limited by the taxpayer's tax liability, but a taxpayer must reduce the amount of these credits by the taxpayer's AMT. For taxable years beginning before 2002, the additional child credit is not reduced by the AMT.

If an individual is subject to AMT in any year, the amount of tax exceeding the taxpayer's regular tax liability is allowed as a credit (the "AMT credit") in any subsequent taxable year to the extent the taxpayer's regular tax liability exceeds his or her tentative minimum tax liability in such subsequent year. For individuals, the AMT credit is allowed only to the extent that the taxpayer's AMT liability is the result of adjustments that are timing in nature. The individual AMT adjustments relating to itemized deductions and personal exemptions are not timing in nature, and no minimum tax credit is allowed with respect to these items.

Legislative Background

Minimum taxes prior to the Tax Reform Act of 1986

Individuals first became subject to an "add-on" minimum tax in 1969 because of a concern about individuals sheltering much or all of their income from Federal income tax by investing in tax shelter activities. The 1969 version of the minimum tax existed until 1982. In addition, in 1978, Congress enacted a minimum tax that, in form, resembles the current AMT. The 1978 tax was payable in addition to all other tax liabilities to the extent it exceeded the individual's regular tax liability. The tax was imposed at flat rate of 20 percent on alternative minimum taxable income in excess of an exemption amount. A taxpayer's alternative minimum

[27] No adjustment is required if the taxpayer materially participates in the activity relating to the research and experimental activities.

tax liability could be reduced by foreign tax credits and refundable credits. An individual's alternative minimum taxable income was his or her adjusted gross income, increased by certain preferences and reduced by alternative tax itemized deductions.

The tax preference items were: (1) dividends excluded from taxable income under prior-law section 116 (prior law allowed an individual to exclude up to $100 of dividends annually); (2) the excess of accelerated over straight-line depreciation in the case of real property; (3) the excess of accelerated over straight-line depreciation (the latter using lengthened recovery periods) in the case of leased personal property; (4) the excess of 60-month amortization over the amount of depreciation otherwise allowable in the case of certified pollution control facilities; (5) the excess of the deduction for expensed mining exploration and development costs over the amount that would be allowable if the costs were capitalized and amortized over a 10-year period; (6) the excess of the deduction for expensed circulation expenditures over the amount that would be allowable if the costs were capitalized and amortized over a three-year period; (7) the excess of the deduction for expensed research and development expenditures over the amount that would be allowable if the costs were capitalized and amortized over a 10-year period; (8) percentage depletion to the extent in excess of the adjusted basis of the depletable property; (9) that portion of net capital gains deductible from gross income (unless the gain related to the sale or exchange of a principal residence); (10) the excess of the fair market value of stock received through the exercise of an incentive stock option over the exercise price; and (11) the amount by which excess intangible drilling costs deducted in the taxable year exceeded the net income from oil, gas, and geothermal properties. An individual could avoid some of the preferences listed above by electing to defer regular tax deductions for circulation expenditures, research and experimental expenditures, intangible drilling costs, mining exploration and developments costs, and depreciation. An individual may have had an incentive to make such an election even though it increased his or her regular taxable income in the year of the election in order to reduce his or her alternative minimum tax liability in future years. The election may have been attractive because the prior-law alternative minimum tax was, in many respects, an "add-on" system (i.e., the timing preferences could not "turn around" and reduce AMTI in subsequent years).

The itemized deductions that an individual could deduct for minimum tax purposes were casualty or theft losses, gambling losses to the extent of gambling gains, charitable deductions, medical deductions to the extent in excess of 10 percent of the taxpayer's adjusted gross income, interest expense on qualified home indebtedness, other interest expense not in excess of qualified net investment income, and deductions for estate tax attributable to income in respect of a decedent.

Changes made by the Tax Reform Act of 1986

The 1986 Act broadened the base of the pre-existing individual alternative minimum tax. In addition, the 1986 Act increased the individual AMT rate to 21 percent, provided phase-outs of the exemption amounts, provided the AMT credit, and changed the individual AMT from essentially an add-on system of preferences to a separate tax system of preferences and adjustments, the latter of which were deferral items that could "turn-around" (i.e., decrease AMTI) over the life of the related property.

Changes made since the Tax Reform Act of 1986

Certain amendments have been made to the individual AMT base and rates since the 1986 Act. The principal changes are described below.

Tax rates and exemptions

The individual AMT rate was raised from 21 percent to 24 percent by the Omnibus Budget Reconciliation Act of 1990 ("1990 Act"). The 1990 Act also increased the top marginal income tax rate applicable to individuals under the regular tax to 31 percent. The Omnibus Budget Reconciliation Act of 1993 ("1993 Act") instituted the two-tier individual AMT rate system of present law (at 26 and 28 percent) and increased the individual AMT exemption amounts. The 1993 Act also added the present-law 36-percent and 39.6-percent marginal income tax rates applicable to individuals under the regular tax.

Depreciation

Several changes have been made to the depreciation adjustment. Prior to 1986, the amount by which accelerated depreciation exceeded straight-line depreciation on real and leased personal property placed in service after 1980 was an AMT preference. In the case of leased personal property, straight-line depreciation was computed by the extending the regular tax recovery period for such property. The 1986 Act retained this preference and generally provided that for property placed in service after 1986 (including personal property not subject to a lease), depreciation for AMT purposes would be computed using (1) the 150-percent declining balance method (for property using an accelerated method for regular tax purposes) or the straight-line method (for property using such method for regular tax purposes) and (2) the recovery periods provided by the alternative depreciation system of section 168(g) (which generally were longer than the lives used for regular tax purposes). The Taxpayer Relief Act of 1997 provided that AMT depreciation is computed using the regular tax recovery periods for property (and AMT method) placed in service after 1998.

Oil and gas provisions

The 1986 Act version of the AMT contained several provisions that related to oil and gas exploration and production. Preferences included (1) the deduction for percentage depletion to the extent the deduction exceeded the adjusted basis of the property and (2) the amount by which excess intangible drilling costs ("IDCs") arising in the taxable year exceeded 65 percent of the net income from oil and gas properties. "Excess IDCs" were the amount by which the regular tax deduction for IDCs exceeded the amount that would have been deducted had such costs been capitalized and amortized over a 120-month period.

The Energy Policy Act of 1992 repealed the individual AMT preferences for the deductions of IDCs and percentage depletion of oil and gas producers. The repeal of the IDC preference could not reduce a taxpayer's AMTI by more than 40 percent (30 percent in 1993) of the amount that the taxpayer's AMTI would have been had the preference not been repealed.

Charitable contributions of appreciated property

Under the regular tax, a taxpayer generally is allowed to deduct the fair market value of appreciated property contributed to a charity. The 1986 Act included a preference that limited a taxpayer's deduction for the charitable contribution of appreciated property to the taxpayer's adjusted basis in the property. The 1990 Act repealed this preference for tangible personal property contributed in taxable years beginning in 1991 and contributions made before July 1, 1992, in taxable years beginning in 1992. The 1993 Act repealed the preference for tangible personal property contributed after June 30, 1992, and other appreciated property contributed after December 31, 1992.

Personal credits

Various tax credits have been added to the Code at various times. For example, the child credit and the HOPE and lifetime learning credits became effective in 1998. The Tax and Trade Relief Extension Act of 1998 and the Tax Relief Extension Act of 1999 (1) allowed the personal nonrefundable credits to offset the regular tax in 1998 and 1999 and both the regular tax and the AMT in 2000 and 2001, and (2) postponed the rule requiring the additional child credit to be reduced by the AMT until taxable years beginning after 2001.

Miscellaneous changes

The Omnibus Budget Reconciliation Act of 1989 made minor changes to the individual AMT. These changes: (1) excepted small home construction contracts from the AMT long-term contract rules and (2) repealed the AMT adjustment for research and development expenditures for individuals who actively participate in the underlying business. The Taxpayer Relief Act of 1997 clarified that farmers may use the installment method for AMT purposes.

Moreover, certain changes have been made to the regular income tax to more closely conform its base to the AMT base. For example, many of the preference limitations contained in the pre-1986 individual alternative minimum tax were enacted, in part, because of a concern about individuals investing in tax shelter activities. The 1986 Act directly addressed this concern with the enactment of the passive activity rules of section 469. Similarly, the AMT adjustments relating to installment sales by dealers and long-term contracts have applied to relatively few taxpayers because since 1986, Congress has, with some exceptions, adopted the AMT treatment for these items for regular tax purposes.

B. Data and Discussion of Issues

Data

Data on taxpayers affected by the AMT

Table 2 presents actual and projected data on individual taxpayers subject to the individual AMT. These data show that, by 2011, 11.2 percent of individual income tax returns will have AMT liability totaling $36.2 billion. As noted below, Table 2 does not include data on individual taxpayers whose regular tax liability is affected by the AMT through the operation of the present-law tax credit limitations.

Table 2.--Actual and Projected Individual Income Tax Returns With Tax Liability Under the Individual Alternative Minimum Tax, 1987-2011

Year	Number of returns paying AMT (thousands)	Percentage of filed returns paying AMT	Excess of AMT liability over regular tax liability ($ billions)
1987	140	0.1%	1.7
1988	134	0.1%	1.0
1989	117	0.1%	0.8
1990	132	0.1%	0.8
1991	244	0.2%	1.2
1992	287	0.3%	1.4
1993	335	0.3%	2.1
1994	369	0.3%	2.2
1995	414	0.4%	2.3
1996	478	0.4%	2.8
1997	616	0.5%	4.0
1998	853	.07%	5.0
1999	data not available	data not available	data not available
2000	data not available	data not available	data not available
2001	1,362	1.1%	5.2
2002	1,866	1.4%	6.0
2003	2,345	1.8%	7.0
2004	3,045	2.2%	8.4
2005	4,134	3.0%	10.3
2006	5,234	3.8%	12.4
2007	6,728	4.8%	15.5
2008	8,649	6.1%	19.4
2009	10,698	7.5%	23.9
2010	13,232	9.1%	29.4
2011	16,366	11.2%	36.2

Note: These statistics represent taxpayers who actually pay AMT and do not include taxpayers whose regular tax liabilities are affected by the AMT through tax credit limitations.
Source: Internal Revenue Service, *Statistics of Income*, 1987-1998; projections for years 2001-2011 from Joint Committee on Taxation staff estimates.

Tables 3 and 4, below, show the projected distribution of individual AMT taxpayers for 2002 and 2010, respectively. These tables demonstrate that the individual AMT will affect an increasing number of middle-income taxpayers over the next 10 years.

Table 3.--Distribution of Individual AMT Taxpayers with AMT Liability Under Present Law, 2002

Income category [1]	Number of returns (thousands)	AMT Taxpayers as a percentage of all taxpayers
Less than $10,000	(2)	(3)
$10,000 to less than $20,000	(2)	(3)
$20,000 to less than $30,000	2	(3)
$30,000 to less than $40,000	15	0.1%
$40,000 to less than $50,000	36	0.3%
$50,000 to less than $75,000	152	0.7%
$75,000 to less than $100,000	236	1.8%
$100,000 to less than $200,000	668	4.9%
$200,000 and over	727	18.1%
Total (all taxpayers)	**1,836**	**1.3%**

[1] The income concept used to place tax returns into income categories is AGI plus: (a) tax-exempt interest; (b) employer contributions to health plans and life insurance; (c) employer share of FICA tax; (d) workers compensation; (e) nontaxable Social Security benefits; (f) insurance value of Medicare benefits; (g) AMT preference items; and (h) excluded income of U.S. citizens living abroad. Categories are measured at 2001 levels. Excludes individuals who are dependents of other taxpayers and taxpayers with negative income, resulting in differences with Table 2.

[2] Less than 500,000.
[3] Less than 0.5 percent
Details may not add to totals due to rounding.
Source: Joint Committee on Taxation.

Table 4--Distribution of Individual AMT Taxpayers with AMT Liability Under Present Law, 2010

Income category[1]	Number of returns (thousands)	AMT Taxpayers as a percentage of all taxpayers
Less than $10,000	(2)	(3)
$10,000 to less than $20,000	(2)	(3)
$20,000 to less than $30,000	11	0.1%
$30,000 to less than $40,000	82	0.5%
$40,000 to less than $50,000	242	1.7%
$50,000 to less than $75,000	1,736	6.3%
$75,000 to less than $100,000	2,273	14.2%
$100,000 to less than $200,000	5,910	27.8%
$200,000 and over	2,957	48.7%
Total (all taxpayers)	**13,211**	**8.5%**

(1) Same income concept as used in Table 2, measured at 2001 levels.
(2) Less than 500,000.
(3) Less than 0.5 percent.
Details may not add due to rounding.
Source: Joint Committee on Taxation.

Effect of the individual AMT on personal credits

A problem with the present-law individual AMT system is the effect on the availability of certain personal credits. Statistics that look only at the percentage of taxpayers who have AMT liability on their tax returns understate the effect of the individual AMT. Under present law, for taxable years after 2001, nonrefundable credits may not reduce regular tax liability below the tentative minimum tax. Thus, individual taxpayers who the Congress intended to be eligible to claim certain nonrefundable personal credits will not be able to claim these credits because of the operation of the individual AMT.

Unlike the standard deduction and the rate bracket breakpoints of the regular income tax, the exemption amount under the AMT is not indexed for inflation. Thus, a taxpayer whose nominal income increases from year to year, but whose real (inflation adjusted) income remains constant year to year, would find that his tentative AMT liability increases year to year in nominal terms, while his regular tax liability remains constant in real terms. This increases the possibility that claiming a personal credit against the regular tax would subject the taxpayer to the AMT. Some have suggested that the lack of indexing is a significant reason for the projected increases in individual AMT taxpayers. For example, in 2000 the staff of the Joint Committee on Taxation estimated that under present law the number of taxpayers subject to the AMT would grow by more than eightfold between 2001 and 2010, but, if the AMT exemption amount were

indexed for inflation the projected growth in the number of taxpayers subject to the AMT would only approximately double.[28]

Tables 5-7, below, show the effect of various elements of the individual AMT on the number of taxpayers projected to be affected by the AMT.

Table 5.--Projected Individual Income Tax Return With Nonrefundable Tax Credits, 2002 and 2010 (in millions of returns)

	Taxable Year 2002	Taxable Year 2010
Returns with nonrefundable credits	47.7	48.6
Returns receiving full credits	17.6	12.0
Returns receiving zero or less than full credits	30.1	36.6
Returns affected by the AMT	1.7	5.0

Source: Joint Committee on Taxation.

Table 6.--Projected Individual Income Tax Returns With Child Credits, 2002 and 2010[(1)] (in millions)

	Taxable Year 2002	Taxable Year 2010
Returns with dependents under age 17	39.4	39.6
Returns receiving full child credits	20.1	13.0
Returns receiving zero or less than full child credit.	19.3	26.6
Returns affected by the AMT	1.0	3.0

[(1)] Includes refundable portion of the credit.
Source: Joint Committee on Taxation.

[28] Joint Committee on Taxation, *Description of Revenue Provisions Contained in the President's Fiscal Year 2001 Budget Proposal* (JCS-2-00), March 6, 2000.

Table 7.--Projected Individual Income Tax Returns With HOPE and Lifetime Learning Credits, 2002 and 2010 (in millions)

	Taxable Year 2002	Taxable Year 2010
Returns with tuition expense	12.9	14.7
Returns receiving full education credit	3.7	2.4
Returns receiving zero or less than full education credit	9.2	12.3
Returns affected by the AMT	0.6	1.4

Source: Joint Committee on Taxation.

These tables show the number of returns claiming nonrefundable personal credits, the child credit, and the HOPE and lifetime learning credits that are affected by the individual AMT. The first line on each table shows the number of returns that could potentially claim the credit. The second line shows those receiving the full credit, while the third line shows those receiving zero or only part of the credit. Thus, the second and third lines sum to the total in the first line. The final line is a subset of the third line, and shows those taxpayers for whom the AMT reduces or eliminates the credit.[29] The final line thus shows that, in 2010, an increasing number of returns claiming these credits are affected by the AMT relative to the number of such returns affected by the AMT in 2002.

The tax reductions proposal submitted by President Bush would increase the number of persons who would be subject to the individual alternative minimum tax or would have their nonrefundable credits (other than the child credit) disallowed by reason of the minimum tax. It is estimated that in 2002, the number of individuals affected by the AMT would increase from 3.5 million (under present law) to 5.9 million and that in 2011 the number of affected individuals would increase from 20.7 million to 35.7 million.

Discussion of Issues

The individual AMT is a separate tax system within the individual income tax system that applies lower tax rates to a broader base of income. As a separate tax system, the AMT should be analyzed in terms of equity, efficiency, growth, and simplicity. In addition, the separate preferences and adjustments within the individual AMT should be subject to the same analysis.

[29] The other taxpayers in the third line who are unable to claim the full credit cannot do so as a result of phaseout provisions, or because they do not have sufficient tax liability to claim the full credit.

Equity

In practice, the AMT has the effect of requiring more taxpayers to remit at least some funds to the Federal Treasury every year than would be the case if only the regular income taxes applied. This occurs if (1) the taxpayer's tentative minimum tax exceeds his or her regular tax liability, or (2) the use of tax credits allowed under the regular tax is limited by the taxpayer's tentative minimum tax. To the extent that taxpayers who outwardly appear to have the ability to pay taxes indeed do pay taxes, some observers conclude that the AMT increases the perceived fairness of the income tax system.

Indeed, the rationale for enacting the original individual minimum tax in 1969 and revising it in 1986 were perceptions that some taxpayers were able to avoid paying tax on relatively large incomes. Minimum tax legislation targeted those deductions, exemptions, exclusions, accounting methods, and tax credits that were considered to have contributed to such results. Some of the enacted AMT preferences and adjustments relate to business or investment income (e.g., the depreciation adjustment and the private activity tax-free bond preference) while others relate to regular-tax items that are more personal in nature (e.g., the denial of personal exemptions and certain itemized deductions).

To assess whether the AMT promotes the overall equity of the tax system, it is necessary to look beyond who remits tax payments to the Federal Treasury to who bears the burden of the AMT. Regarding the individual income tax, while economists generally believe that income taxes on wages are borne by taxpayers who supply labor, there is disagreement concerning the incidence of taxes that affect the returns earned by capital such as the taxation of interest, dividends, capital gains, and business income from pass-through entities. Economists generally believe that businesses do not bear the burden of the tax (including the individual AMT), but rather individuals bear the burden of the tax. There is disagreement, however, over which individuals bear the burden of a business income tax, whether it is customers in the form of higher prices, workers in the form of reduced wages, owners of all capital in the form of lower after-tax returns on investment, or some combination of these individuals.

The uncertainty regarding the incidence of income taxes on the returns to capital make it difficult to assess the effect the AMT has on the equity of the burden of the income tax system. The AMT raises average tax rates for affected taxpayers. That is, the AMT increases the amount of the affected taxpayer's tax liability as a percentage of his or her income. At the individual level, higher-income taxpayers are more likely to be AMT taxpayers than are lower-income taxpayers (see Table 3 above). If the burden of the taxes were to rest with the affected taxpayers, the individual AMT might increase the overall progressivity of the income tax system.

Some analysts argue that the AMT promotes horizontal equity by taxing more equally taxpayers who have the same economic capacity but choose to engage in different patterns of tax-favored activities. Other analysts note that in a market economy, investment by taxpayers would be expected to equilibrate risk-adjusted, after-tax returns. As a consequence, the prices of tax-favored investments would be bid up (or their quantity increase) and the prices of tax-disfavored investments would fall (or their quantity decrease). In equilibrium, the pre-tax returns of tax-favored and tax-disfavored investments would differ, but their after-tax returns would be the same. For example, tax-exempt bonds trade at interest rates lower than otherwise

comparable taxable bonds. This is because the tax-exempt borrower does not have to offer as great an interest rate to the lender to provide the lender with a competitive after-tax return. If after-tax returns equilibrate, analysts may question whether a horizontal inequity existed prior to the enactment of the AMT.

The AMT also raises equity issues with respect to preference items that are personal in nature. For example, some believe that it is fair that families with multiple dependents pay less tax than families with fewer dependents and support the regular-tax allowance of personal exemptions and child credits to further this goal. The AMT, in disallowing these exemptions and credits, may frustrate this perception of fairness.

Efficiency and growth

A tax system is efficient if it does not distort the choices that would be made in the absence of the tax system. No tax system can be fully efficient. Whether the AMT contributes to the efficiency of the United States tax system depends on the extent to which it reduces other inefficiencies in the tax system and the extent to which it creates new inefficiencies. As an income tax, the AMT reduces the return to work (labor income is taxed) and saving (investment income is taxed). As such, the AMT may distort decisions to supply labor and capital. The size of the marginal tax rate is one of the primary determinants of the size of any distortion created.[30] However, the degree of additional distortion, if any, created by the AMT depends upon the tax rates of the AMT compared to those of the regular income tax. In this regard, it is useful to distinguish the effect on labor income from the effect on investment income.

The measurement of labor income is nearly identical under the regular income tax and the AMT. The two differences arise in the measurement of income from certain incentive stock options and the measurement of net labor income when the taxpayer incurs expenses categorized as miscellaneous itemized expenses. If labor income is measured identically under the regular income tax and the AMT, then any distortions in labor supply are mitigated if a taxpayer subject to the AMT has a lower marginal tax rate under the AMT than he or she would under the regular tax. Table 3 indicates that most AMT taxpayers have annual income of $100,000 or greater. Generally such taxpayers face marginal tax rates of 28 percent or greater under the regular tax. Because the AMT has marginal tax rates of 26 or 28 percent, many such taxpayers have their labor income taxed at a lower rate under the AMT than if they were under the regular tax. Not all taxpayers subject to the AMT would otherwise be in the 28-percent tax bracket and above under the regular income tax. Some AMT taxpayers would otherwise be in 15-percent tax bracket. For these taxpayers the AMT may increase distortions in labor supply. However, because most AMT taxpayers would be in higher tax brackets under the regular income tax, overall the AMT, by having lower marginal tax rates on labor income, may mitigate distortions in labor supply created by the regular income tax.

[30] For a more detailed discussion of marginal tax rates and possible distortions of labor supply and saving under an income tax see Joint Committee on Taxation, *Overview of Present Law and Economic Analysis Relating to Marginal Tax Rates and the President's Individual Income Tax Rate Proposal (*JCX-6-01), March 6, 2001.

In the two cases where labor income is measured differently under the regular income tax and the AMT, the AMT may increase the rate of tax on such forms of labor income, thereby seemingly increasing distortions in labor supply. However, by discouraging taxpayers from structuring their compensation to receive tax-favored remuneration, efficiency may be increased.

A caveat to this discussion is warranted. For the AMT to mitigate or exacerbate a distortion under the regular tax the taxpayer must know that he or she will be subject to the AMT. If a taxpayer is uncertain whether the tax rates of the AMT or the regular tax will apply it is difficult to assess the taxpayer's behavioral response. In general, if a taxpayer subject to the AMT views himself or herself as only temporarily subject to the AMT, he or she is less likely to view the AMT tax rates as the relevant tax rates upon which to plan labor supply decisions.

The same general analysis of comparing the possible distorting effects of the difference in marginal tax rates under the regular income tax and the AMT applies to taxpayer's decisions to save (to supply capital) in response to tax rates on investment income. There are several more cases where investment income is measured differently under the AMT than under the regular income tax than was the case with the measurement of labor income. By discouraging some taxpayers from undertaking what are otherwise tax-favored investments, efficiency may be increased to the extent that the tax-favored investments are inefficient. However, the AMT generally does not eliminate tax-favored treatment of certain activities or investments, but rather limits which taxpayers may take full advantage of the tax-favored treatment provided by the regular income tax. In addition, limiting which taxpayers can profitably undertake tax-favored activities could lead to more efficient investors finding the activity unprofitable, while less efficient investors find the activity profitable. Moreover, some tax-favored activities may be permitted as part of the regular income tax as a way to reduce some other inefficiency in the economy. These arguments might suggest that efficiency could be better improved by changes in the regular income taxes. The aggregate effect of the AMT on the efficient allocation of capital across various investment opportunities may be modest. Since the Taxpayer Relief Act of 1997 conformed depreciation recovery periods for both the regular income tax and the AMT, the number of investment opportunities on which the income might subject a taxpayer to the AMT rather than the regular tax has been modest in comparison to aggregate investment in the United States.

However, because of the increasing number of taxpayer subject to the AMT, there is another avenue by which the AMT may affect the level of investment in the United States and thereby affect economic growth. By increasing average tax rates (the total tax paid by certain taxpayers), the AMT may reduce the cash flow of potential investors. If, as some analysts believe, investors' cash flows are important to investment decisions, the AMT may reduce aggregate investment. Further, the effect of the AMT on effective marginal tax rates, and thereby on the cost of capital, may change the incentive to undertake marginal investment projects and thereby affect the level of aggregate investment.

Some specific preferences and adjustments within the AMT seem inconsistent with other parts of the AMT and thus may lead to inefficiencies. For example, it is often presumed that one goal of the AMT is to apply tax to a better measure of economic income, relative to the regular tax. It is generally conceded that in measuring economic income, deductions should be allowed for expenses incurred in the production of income. However, the AMT disallows the deduction

of miscellaneous itemized deductions--including un-reimbursed employee business expenses and investment expenses that relate to the production of income. The disallowance of such deductions may lead to inefficiencies as taxpayers may be discouraged from certain otherwise profitable investments or activities or encouraged to rearrange their affairs to secure AMT deductions for such costs (e.g., by attempting to move such deductions "above-the-line").

Simplicity and compliance

The AMT requires a calculation of a second income tax base and computation of a tax on that base, so the present tax system, with an AMT, is not as simple to administer or comply with as would be the same system without an AMT. As detailed above, relatively few taxpayers currently are subject to the AMT. However, this observation understates the extent to which the AMT imposes a compliance burden on taxpayers. Many taxpayers must undertake the AMT calculation to determine whether, in fact, they are liable or whether the utilization of certain credits is limited. There are no studies that specifically measure compliance costs arising from the individual AMT. Tables 2, 5, 6, and 7, above, indicate that many more individuals will become affected by the AMT in the future.

In order to reduce the burden of the alternative individual minimum tax, the tax could be amended in a number of ways. The exemption amounts could be indexed or increased so as to reduce the number of individuals subject to the AMT; the deduction for personal exemptions and the standard deduction could be allowed in computing AMTI; the minimum tax rates could be reduced; the nonrefundable personal credits could be allowed to offset the minimum tax after 2001; or the alternative minimum tax could be repealed.