

**PRESENT LAW AND ISSUES
RELATING TO THE INDIVIDUAL
ALTERNATIVE MINIMUM TAX ("AMT")**

Scheduled for a Hearing

Before the

HOUSE COMMITTEE ON WAYS AND MEANS

on February 4, 1998

Prepared by the Staff

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JOINT COMMITTEE ON TAXATION

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CONTENTS

	<u>Page</u>
INTRODUCTION	1
I. OVERVIEW	2
II. PRESENT LAW AND LEGISLATIVE BACKGROUND	4
A. Present Law	4
B. Legislative Background	8
III. ANALYSIS OF ISSUES	12
A. Data on Taxpayers Affected by the AMT	12
B. Issues	18

INTRODUCTION

The House Committee on Ways and Means has scheduled a public hearing on February 4, 1998, on issues relating to the statutory and effective individual income tax rates, including the alternative minimum tax ("AMT") on individuals. This document,¹ prepared by the staff of the Joint Committee on Taxation, describes present-law AMT rules, provides actual and projected data on the AMT and AMT taxpayers, and discusses issues relating to the present-law individual AMT.

Part I of the document is an overview of the present-law individual AMT. Part II describes the present-law AMT rules and the legislative background of the AMT. Part III is an analysis of the issues presented by the present-law AMT, including data on the individual AMT and individual AMT taxpayers.

¹ This document may be cited as follows: Joint Committee on Taxation, *Present Law and Issues Relating to the Individual Alternative Minimum Tax ("AMT")* (JCX-3-98), February 2, 1998.

I. OVERVIEW

Present law and background

Present law imposes a minimum tax, known as the alternative minimum tax ("AMT"), on an individual taxpayer to the extent the taxpayer's minimum tax liability exceeds his or her regular tax liability. The individual AMT is imposed at rates of 26 and 28 percent on alternative minimum taxable income in excess of a phased-out exemption amount. Present law also imposes a minimum tax on corporations at a 20-percent rate upon an alternative minimum taxable income base that generally is broader than that applicable to individuals.

Alternative minimum taxable income 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. Thus, for affected taxpayers, when compared to the regular tax, the AMT imposes a lower marginal rate of tax on a broader base of income.

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 in any subsequent taxable year to the extent the taxpayer's regular tax liability exceeds his or her tentative minimum tax in such subsequent year and to the extent the taxpayer's AMT liability is a result of adjustments that are timing in nature. Most individual AMT adjustments are not timing in nature.

In addition, the nonrefundable credits available to an individual to reduce his or her regular tax liability generally may not reduce the individual's minimum tax liability. Thus, by acting as a floor for credit utilization, the AMT may affect the tax liability of individuals who do not actually pay the AMT.

Individuals have been subject to some version of a minimum tax since 1969. The current format of the AMT was enacted in 1978. The Tax Reform Act of 1986 broadened the base of the individual AMT. Since 1986, the base of the individual AMT has been somewhat narrowed and the marginal tax rates have been increased (generally, in conjunction with increases in the marginal income tax rates applicable to individuals under the regular tax).

Analysis of issues

Relatively few individuals currently are subject to the AMT. Those who are so subject tend to be individuals with higher adjusted gross incomes. However, over time, relatively more individuals will become subject to the AMT, including increasingly more middle-income individuals. These trends largely can be attributed to the fact that several features of the regular tax (e.g., personal exemptions, standard deductions, tax bracket break-points) are indexed for inflation, but similar features are not so indexed for AMT purposes.

The goal of all minimum taxes is for taxpayers with some measure of economic income to pay at least a minimum amount of income tax. This is generally accomplished by disallowing or limiting the use of specific deductions, exemptions, exclusions, accounting methods, and tax credits.

As a separate system within the regular tax system, the AMT should be analyzed in terms of equity, efficiency, growth, and simplicity. The individual AMT may act to increase the progressivity of the income tax system. The effects of the AMT on the cost of capital and aggregate investment is uncertain. The AMT creates additional compliance burdens and may be viewed as complex by taxpayers.

II. PRESENT LAW AND LEGISLATIVE HISTORY

A. Present Law

In general

Present law imposes a minimum tax on an individual to the extent the taxpayer's minimum tax liability exceeds his or her regular tax liability.² This alternative minimum tax ("AMT") is imposed upon 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. Since 1993, 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. 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.

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 the 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

² Present law also imposes a 20-percent alternative minimum tax on corporations. The income base for the corporate alternative minimum tax is broader than the base applicable to individuals. For a discussion of the corporate alternative minimum tax, see, Joint Committee on Taxation, *Present Law and Issues Relating to the Corporate and Individual Alternative Minimum Tax (AMT)* (JCX-22-95), May 2, 1995.

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 or passive activities are denied.³

Adjustments in computing AMTI

The adjustments that all taxpayers (including corporations) must make 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.

³ 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."

The adjustments applicable only to individuals are:

- (1) Miscellaneous itemized deductions are not allowed;
- (2) 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;
- (3) Medical expenses are allowed only to the extent they exceed ten percent of the taxpayer's adjusted gross income;
- (4) Standard deductions and personal exemptions are not allowed;
- (5) The amount allowable as a deduction for circulation expenditures must be capitalized and amortized over a 3-year period;
- (6) The amount allowable as a deduction for research and experimental expenditures must be capitalized and amortized over a 10-year period;⁴ and
- (7) 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 credits allowed under the regular tax generally are not allowed against the AMT. The earned income credit and the child credit of those taxpayers with three or more qualified children are refundable credits and may offset the taxpayer's tentative minimum tax. However, a taxpayer must reduce these refundable credits by the amount the taxpayer's tentative minimum tax exceeds his or her regular tax liability.

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 in such subsequent year. For individuals, the AMT credit is allowed only to the extent the taxpayer's AMT liability is a result of adjustments that are timing in nature. Most individual AMT

⁴ No adjustment is required if the taxpayer materially participates in the activity that relates to the research and experimental expenditures.

adjustments relate to itemized deductions and personal exemptions and are not timing in nature.⁵

⁵ See, Robert H. Harvey and Jerry Tempalski, "The Individual AMT: Why It Matters," National Tax Journal, Vol. L, No. 3, September 1997, 453, at 468, which estimates that personal exemptions, standard deductions, State and local tax deductions, medical expense deductions, and miscellaneous itemized deductions collectively comprise 73.4 percent of individual AMT preferences and adjustments for 1997.

B. 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 with 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.⁶ 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 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 3-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 that were deductible from gross income (unless the gain related to the sale or exchange of a principal residence);⁷ (10) the excess of the fair market value 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

⁶ The goal of all minimum taxes is for taxpayers with some measure of economic income to pay at least a minimum amount of income tax. The difference between an "add-on" minimum tax and an AMT is that under the "add-on" method, taxpayers compute their regular tax liability and add to it a separate tax on specific preference items. Under an AMT, taxpayers generally compute their taxable incomes and tax liabilities twice--once under the regular system and again under the AMT system--and pay the greater amount.

⁷ Prior to the 1986 Act, individuals could deduct from income up to 60 percent of net capital gains.

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. The 1986 Act also instituted the corporate AMT, replacing an "add-on" minimum tax.

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 a flat 21 percent to a flat 24 percent by the Omnibus Budget Reconciliation Act of 1990 ("1990 Act"). The 1990 Act 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 (at 26 and 28 percent) of present law and increased the individual AMT

exemption amounts.⁸ The 1993 Act 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 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.⁹ 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" was 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 1990 Act provided a special energy deduction for purposes of reducing AMTI. The deduction was based on a specific portion of the various oil and gas related preference and ACE adjustment items. Specifically, the special energy deduction was initially determined by determining the taxpayer's IDC preference and marginal production depletion preference. The amount of these preferences was the amount that the taxpayer's AMTI would have been reduced had the AMT rules relating to IDCs and percentage depletion on marginal properties not applied. The IDC preference was divided between qualified exploratory costs and other costs and each

⁸ Prior to the 1993 Act, the AMT exemptions amounts were \$40,000 in the case of married individuals filing a joint return and surviving spouses; \$30,000 in the case of other unmarried individuals; and \$20,000 in the case of married individuals filing a separate return.

⁹ As discussed above, the individual minimum taxes in effect before the 1986 Act also contained preferences with respect to oil and gas exploration and production.

portion, and the marginal production depletion preference, were multiplied by specified percentages. These three products were added together to comprise the special energy deduction. The special energy deduction was not allowed to the extent it exceeded 40 percent of the taxpayer's AMTI (determined without this deduction and net operating losses). In addition, the special energy deduction was phased-out if the average price of crude oil exceeded \$28 a barrel in the prior year.

The special energy deduction was repealed in the Energy Policy Act of 1992, which also repealed the preferences for the deductions of IDCs and percentage depletion of oil and gas producers other than integrated oil companies. 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.

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 with 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.

III. ANALYSIS OF ISSUES

A. Data on Taxpayers Affected by the AMT

Relatively few individuals have been subject to the AMT. Table 1 presents individual AMT data and projections for the 1987-2008 tax years.

Table 1.--Actual and Projected Individual Income Tax Returns With Tax Liability Under the Individual Alternative Minimum Tax, 1987-2008

<u>Year</u>	<u>Number of returns paying AMT (thousands)</u>	<u>Percentage of returns paying AMT</u>	<u>Excess of AMT liability over regular tax liability (\$ billions)</u>
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	data not available		
1997	data not available		
1998	856	0.7	4.3
1999	952	0.8	4.6
2000	1,141	0.9	5.1
2001	1,391	1.1	5.7
2002	1,782	1.4	6.5
2003	2,378	1.9	7.6
2004	2,905	2.2	8.9
2005	3,942	3.0	10.6
2006	5,078	3.8	12.9
2007	6,587	4.9	15.9
2008	8,830	6.5	19.8

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. See Tables 5, 6, and 7 for such data.

Source: Internal Revenue Service, *Statistics of Income*, 1987-1995; projections for years 1998-2008 from Joint Committee on Taxation staff estimates.

Tables 2 and 3 below report how individual AMT taxpayers are estimated to be distributed across various income classes in 1998 and 2008.

**Table 2.--Distribution of Individual AMT Taxpayers
with AMT Liability under Present Law, 1998**

<u>Income category</u> (1)	<u>Number of returns (thousands)</u>	<u>AMT taxpayers as a percentage of all taxpayers</u>
Less than \$10,000	(2)	(3)
\$10,000 to less than 20,000	1	(3)
\$20,000 to less than \$30,000	(2)	(3)
\$30,000 to less than \$40,000	9	0.1
\$40,000 to less than \$50,000	14	0.1
\$50,000 to less than \$75,000	68	0.3
\$75,000 to less than \$100,000	97	1.0
\$100,000 to less than \$200,000	270	3.2
\$200,000 and over	<u>388</u>	<u>17.9</u>
Total (all taxpayers)	848	0.8

(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. Excludes individuals who are dependents of other taxpayers and taxpayers with negative income, resulting in differences with Table 1.

(2) Less than 500

(3) Less than .05 percent

Details may not add due to rounding.

Source: Staff of the Joint Committee on Taxation

**Table 3.--Distribution of Individual AMT Taxpayers
with AMT Liability under Present Law, 2008**

<u>Income category(1)</u>	<u>Number of returns (thousands)</u>	<u>AMT taxpayers as a percentage of all taxpayers</u>
Less than \$10,000	(2)	(3)
\$10,000 to less than 20,000	(2)	(3)
\$20,000 to less than \$30,000	9	(3)
\$30,000 to less than \$40,000	157	0.9
\$40,000 to less than \$50,000	248	1.8
\$50,000 to less than \$75,000	1,356	5.8
\$75,000 to less than \$100,000	2,700	19.7
\$100,000 to less than \$200,000	3,043	26.6
\$200,000 and over	<u>1,310</u>	<u>42.7</u>
Total (all taxpayers)	8,822	7.2

(1) Same income concept as used in Table 2, measured at 1998 levels.

(2) Less than 500

(3) Less than .05 percent

Details may not add due to rounding.

Source: Staff of the Joint Committee on Taxation

The increase in the number of taxpayers subject to the AMT largely can be attributed to the fact that the personal exemptions, standard deduction, and tax bracket break points of the regular tax are indexed for inflation, while the AMT exemption amounts and tax bracket break point are not indexed for inflation. Proposals that would increase or index these amounts would decrease the number of taxpayers subject to the AMT and reduce the tax burden of those individuals otherwise subject to the AMT.¹⁰ Even with indexing, one would expect some growth in AMT taxpayers as real (i.e., inflation-adjusted) incomes rise over time.

The lack of indexing in the AMT also explains the increase of AMT taxpayers in the middle-income categories. Under present law, the relatively large AMT exemption amounts¹¹

¹⁰ Both the House- and Senate-passed versions of H.R. 2014, the "Taxpayer Relief Act of 1997," would have increased or indexed the exemption amounts of the individual AMT. However, the final conference agreement on H.R. 2014 as passed by the Congress and signed by the President, did not contain any provision to change the AMT exemption amounts (P.L. 105-34, August 5, 1997).

¹¹ The exemptions 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

shelter most of a low- or middle-income taxpayer's AMTI from tax. However, over time, with inflation, a taxpayer's income is expected to grow in nominal dollars. Most of this inflated income of a middle-income individual will remain subject to tax at a 15-percent rate for regular tax purposes because the personal exemptions, standard deduction, and tax bracket break points of the regular tax are indexed for inflation. However, for AMT purposes, relatively less of the taxpayer's inflated income will be sheltered by the unindexed AMT exemption amount and the amount not sheltered will become subject to the higher AMT rate of 26 percent. Because the AMT exemption amounts are phased out over relatively high levels of AMTI, indexing these amounts would provide benefits to taxpayers in all income classes.¹²

Table 4 demonstrates the results if the AMT exemption amounts were indexed for inflation, starting in 1999. With indexing, the number of taxpayers subject to AMT and the amount of AMT collected is expected to remain relatively constant.

**Table 4.--Projected Individual Income
Tax Returns With Tax Liability Under the Individual
AMT If Exemptions Were Indexed, 1999-2008**

<u>Year</u>	<u>Number of returns paying AMT (thousands)</u>	<u>Percentage of returns paying AMT</u>	<u>Excess of AMT liability over regular tax liability (\$ billions)</u>
1999	874	0.7	4.5
2000	908	0.7	4.7
2001	917	0.7	5.0
2002	962	0.8	5.3
2003	1,032	0.8	5.7
2004	1,060	0.8	6.1
2005	1,135	0.8	6.6
2006	1,224	0.9	7.1
2007	1,342	1.0	7.7
2008	1,482	1.0	8.4

Source: Staff of the Joint Committee on Taxation

\$22,500 in the case of married individuals filing a separate return.

¹² The phase-out ranges are \$150,000 to \$330,000 of AMTI for married individuals filing a joint return and surviving spouses; \$112,500 to \$262,500 of AMTI for other unmarried individuals; and \$75,000 to \$165,000 of AMTI for married individuals filing singly.

As described above in Part II. A., above, the AMT acts as a floor with respect to the utilization of nonrefundable credits in that a taxpayer is allowed to reduce his or her regular tax liability with otherwise allowable credits only to the extent the taxpayer's regular tax exceeds his or her tentative minimum tax. Tables 5, 6, and 7 demonstrate the estimated effects of the AMT on all nonrefundable tax credits, the child credit, and the education credits, respectively. Projections on the child and education credits are provided because these credits were only recently enacted by the Congress in 1997, they significantly increased the number of taxpayers eligible for nonrefundable credits, and they were targeted toward taxpayers with middle incomes.

Consistent with the projections in Table 1, relatively few taxpayers currently have tax credit utilization that is limited because of the AMT. However, over time, the number of taxpayers subject to this limitation is expected to increase. This pattern is consistent with the expected increase in the number of AMT taxpayers.

**Table 5.--Projected Individual Income Tax Returns
With Nonrefundable Tax Credits, 1998 and 2008 (1)
(in millions)**

	Taxable Year <u>1998</u>	Taxable Year <u>2008</u>
Returns with nonrefundable credits	38.1	38.7
Returns receiving full credits	25.2	19.5
Returns receiving zero or less than full credits	12.9	19.2
Returns receiving zero or less than full credits due to AMT limitations	0.7	8.9

(1) Measured after any phase-out limitations.

Source: Joint Committee on Taxation

**Table 6.--Projected Individual Income Tax Returns
With Child Credits, 1998 and 2008(1)
(in millions)**

	Taxable Year <u>1998</u>	Taxable Year <u>2008</u>
Returns with dependents under age 17	38.1	39.1
Returns receiving full child credit	23.0	17.4
Returns receiving zero or less than full child credit	15.1	21.7
Returns receiving zero or less than full child credit due to AMT limitations	0.5	7.9

(1) Includes refundable portion of the credit.

Source: Joint Committee on Taxation

**Table 7.--Projected Individual Income Tax Returns
With HOPE and Lifetime Learning Credits, 1998 and 2008
(in millions)**

	Taxable Year <u>1998</u>	Taxable Year <u>2008</u>
Returns with tuition expense	11.6	14.1
Returns receiving full education credit	6.2	4.7
Returns receiving zero or less than full education credit	5.4	9.4
Returns receiving zero or less than full education credit due to AMT limitations	0.3	3.3

Source: Joint Committee on Taxation

B. Issues

The individual AMT is a separate system within the individual income tax system that applies lower tax rates to broader bases of income. As a separate 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 may be subject to the same analysis.

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 argue that businesses do not bear the burden of the tax (including the 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.¹³

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 2 above). If the burden of the taxes were to rest with the

¹³ For a discussion of incidence of taxes on the return to capital, see, Joint Committee on Taxation, *Methodology and Issues in Measuring Changes in the Distribution of Tax Burdens* (JCS-7-93), June 14, 1993, pp. 44-51.

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.¹⁴ 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.¹⁵ 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. 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

¹⁴ This argument was stronger upon enactment of the Tax Reform Act of 1986 than it is today. Since 1986, several preferences and adjustments have been eliminated or modified, including those relating to charitable gifts of appreciated property, percentage depletion and intangible drilling costs for oil and gas properties, installment sales of farmers, and depreciation for tangible property.

¹⁵ Andrew B. Lyon, "The Alternative Minimum Tax: Equity, Efficiency, and Incentive Effects," in *Economic Effects of the Corporate Alternative Minimum Tax*, (Washington, D.C.: American Council for Capital Formation Center for Policy Research), 1991, pp. 51-82. See also, Andrew B. Lyon, *Cracking the Code: Making Sense of the Corporate Alternative Minimum Tax*, (Washington, D.C.: The Brookings Institution Press), 1997.

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.¹⁶

In addition, 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 the investment decision, 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 unreimbursed 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.

Tables 1, 5, 6, and 7, above, indicate that many more individuals will become affected by the AMT in the future. There are no studies that specifically measure compliance costs arising from the individual AMT. Indirect evidence of the complexity imposed by the individual AMT may be the increased utilization of the services of paid tax preparers by individual taxpayers subject to the individual AMT. In 1988, 14 percent of taxpayers with AGI of \$100,000 or more and no significant farming or self-employment income prepared their own tax returns. Of taxpayers with AGI of \$100,000 or more and significant income

¹⁶ Congress has, in certain instances, conformed the regular tax base to the broader AMT base. For example, the regular tax rules applicable to installment sales and long-term contracts generally have been amended to conform to the AMT treatment. In other instances, the AMT rules have been liberalized to conform to the regular tax treatment (e.g., the use of the same recovery periods for depreciable property).

from self-employment or farming, nine percent and four percent of taxpayers prepared their own returns. By contrast, only one percent of all taxpayers subject to the individual AMT prepared their own returns.¹⁷ If taxpayers subject to the AMT are more likely to have complicated financial affairs, they might use paid tax preparers even in the absence of the AMT. However, Tables 2 and 3 indicate that middle-income taxpayers, whose financial affairs are less likely to be complicated, are more likely to become subject to the AMT in the future and thus may be faced with more complicated tax compliance burdens.

¹⁷ Based on tabulations of the staff of the Joint Committee on Taxation of the 1988 IRS Taxpayer Compliance Measurement Program (TCMP).