

**PRESENT LAW AND BACKGROUND RELATING TO
THE INDIVIDUAL ALTERNATIVE MINIMUM TAX**

Scheduled for a Public Hearing
Before the
SUBCOMMITTEE ON TAXATION AND IRS OVERSIGHT
of the
SENATE COMMITTEE ON FINANCE
on May 23, 2005

Prepared by the Staff
of the
JOINT COMMITTEE ON TAXATION



May 20, 2005
JCX-37-05

CONTENTS

	<u>Page</u>
INTRODUCTION	1
EXECUTIVE SUMMARY	2
I. PRESENT LAW AND BACKGROUND RELATING TO THE INDIVIDUAL ALTERNATIVE MIMIMUM TAX.....	4
A. Present Law.....	4
B. Legislative Background	8
II. DATA AND DISCUSSION OF ISSUES.....	10
A. Data	10
B. Discussion of Issues.....	15

INTRODUCTION

The Subcommittee on Taxation and IRS Oversight of the Senate Committee on Finance has scheduled a public hearing on May 23, 2005, on the Individual Alternative Minimum Tax (“AMT”). This document,¹ prepared by the staff of the Joint Committee on Taxation, includes a description of present law and analysis relating to the individual AMT.

¹ This document may be cited as follows: Joint Committee on Taxation, “*Present Law and Background Relating to the Individual Alternative Minimum Tax.*” (JCX-37-05), May 20, 2005.

EXECUTIVE SUMMARY

Present law

Present law imposes an alternative minimum tax (“AMT”) on individuals, estates, and trusts. In general terms, 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.

The AMT is the amount by which a taxpayer's “tentative minimum tax” exceeds the taxpayer's regular income tax for the taxable year. The tentative minimum tax is the sum of: (1) 26 percent of so much of the “taxable excess” as does not exceed \$175,000 (\$87,500 in the case of a married individual filing a separate return) and (2) 28 percent of the remaining “taxable excess”. The taxable excess is the amount by which alternative minimum taxable income (“AMTI”) exceeds the applicable exemption amount. The exemption amounts vary based on filing status, and are phased out for individuals with AMTI in excess of certain levels. The exemption amounts and the break points for the AMT rates and exemption phaseout points are not indexed for inflation.

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.

Legislative background

The first comprehensive AMT was enacted in 1982. The purpose of the AMT, as stated in the legislative history, was to ensure that no taxpayer with substantial economic income should be able to avoid all tax liability by using exclusions, deductions, and credits. The AMT provisions enacted in 1982 are the foundation of the present-law AMT. At that time, in computing AMTI, the deduction for State and local taxes, the deduction for personal exemptions, the standard deduction, and the deduction for interest on home equity loans were not allowed, and the gain on incentive stock options was includible in AMTI. These remain the principal preferences and adjustments under present law.

Since 1982, the rules relating to the AMT have been changed several times. These changes have had various effects, in some cases increasing the impact of the AMT and in other cases reducing the impact of the AMT.

Data and discussion

Taxpayers may be affected by the AMT in two principal ways: (1) they may have an AMT liability, or (2) the use of credits may be restricted because nonrefundable credits may not be used to reduce tax liability below that of the tentative minimum tax. It is estimated that, by 2010, over 20 percent of individual taxpayers will be affected by the AMT. The aggregate amount of such effect is approximately \$110 billion in additional tax liability.

Beginning in 2006, an increasing number of middle-income taxpayers will be affected by the AMT. The principal reason for this increase is that, beginning in 2006, the AMT exemption levels revert to the levels in effect prior to 2001 and certain nonrefundable personal credits are no

longer allowed against the AMT. Even more taxpayers will be affected by the AMT in each passing year because exemption levels are not indexed for inflation while the regular income tax parameters generally are indexed for inflation.

As a separate tax system, the AMT should be analyzed as any other tax system—on the basis of equity, efficiency, effect on economic growth, and simplicity. In addition, the separate preferences and adjustments within the individual AMT should be subject to the same analysis.

To assess whether the AMT promotes overall equity depends on who bears the burden of the tax. There is disagreement among economists as to who bears the burden of the portions of the AMT relating to business activities, making assessments of the effect of the AMT more difficult for such taxpayers. To the extent the AMT tends to raise the average tax liability of higher income taxpayers, the individual AMT might increase the overall progressivity of the tax system.

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 can be fully efficient, and thus the efficiency of the AMT is best judged against the regular income tax. The AMT imposes marginal tax rates on income that differ from those under the regular income tax. To the extent a taxpayer faces higher marginal rates under the AMT, the AMT would be more distortionary with respect to the individual's decisions to supply labor and to save and invest. The AMT raises certain taxpayer's marginal tax rates and lowers others, and thus it is not clear the extent to which the AMT induces additional distortions. The AMT measures certain investment income differently than the regular tax, possibly discouraging investment in those activities relative to other activities for some taxpayers. However, it is not necessarily the case that the regular tax treatment of such items is preferable on efficiency grounds to the AMT treatment, and thus the overall effect of the AMT on the efficiency of investment choices is not clear.

The AMT adds to complexity because it requires a calculation of a second income tax base and computation of a tax on that base. Some argue that this effect is reduced because of the use of tax preparation software. Some counter this by saying that a tax system should not be so complex as to require the use of software by many individuals.

I. PRESENT LAW AND BACKGROUND RELATING TO THE INDIVIDUAL ALTERNATIVE MINIMUM TAX

A. Present Law

In general

An alternative minimum tax (“AMT”) is imposed on an individual, estate, or trust in an amount by which the tentative minimum tax exceeds the regular income tax for the taxable year. The tentative minimum tax is the sum of (1) 26 percent of so much of the taxable excess as does not exceed \$175,000 (\$87,500 in the case of a married individual filing a separate return) and (2) 28 percent of the remaining taxable excess. The taxable excess is the amount by which the alternative minimum taxable income (“AMTI”) exceeds the exemption amount. The maximum tax rates on net capital gain and dividends used in computing the regular tax are used in computing the tentative minimum tax. AMTI is taxable income adjusted to take account of specified tax preferences and adjustments.

The exemption amounts are: (1) \$58,000 (\$45,000 in taxable years beginning after 2005) in the case of married individuals filing a joint return and surviving spouses; (2) \$40,250 (\$33,750 in taxable years beginning after 2005) in the case of other unmarried individuals; (3) \$29,000 (\$22,500 in taxable years beginning after 2005) in the case of married individuals filing separate returns; and (4) \$22,500 in the case of an estate or trust. 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.

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 each mineral property (other than oil and gas properties) at the end of the taxable year (sec. 57(a)(1)).
2. The amount by which excess intangible drilling costs (i.e., expenses in excess the amount that would have been allowable if amortized over a 10-year period) exceed 65 percent of the net income from oil, gas, and geothermal properties. This preference applies to independent producers only to the extent it reduces the producer's AMTI (determined without regard to this preference and the net operating loss deduction) by more than 40 percent (sec. 57(a)(2)).

3. Tax-exempt interest income on private activity bonds (other than qualified 501(c)(3) bonds) issued after August 7, 1986 (sec. 57(a)(5)).
4. Accelerated depreciation or amortization on certain property placed in service before January 1, 1987 (sec. 57(a)(6)).
5. Seven percent of the amount excluded from income under section 1202 (relating to gains on the sale of certain small business stock (sec. 57(a)(7)).

In addition, losses from any tax shelter farm activity or passive activities are not taken into account in computing AMTI (sec. 58).

Adjustments in computing AMTI

The adjustments that individuals must make to compute AMTI are:

6. Depreciation on property placed in service after 1986 and before January 1, 1999, is 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 (rather than the alternate depreciation system recovery periods) and the AMT methods described in the previous sentence. Depreciation on property acquired after September 10, 2001, which is allowed an additional allowance under section 168(k) for the regular tax is computed without regard to any AMT adjustments (sec. 56(a)(1)).
7. Mining exploration and development costs are capitalized and amortized over a 10-year period (sec. 56(a)(2)).
8. Taxable income from a long-term contract (other than a home construction contract) is computed using the percentage of completion method of accounting. (sec. 56(a)(3))
9. 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), is 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 (sec. 56(a)(5)).
10. Miscellaneous itemized deductions² are not allowed (sec. 56(b)(1)(A)(i)).

² Miscellaneous itemized deductions are those deductions which are allowable for purposes of the regular tax only to the extent they exceed two percent of adjusted gross income.

11. Deductions for State, local, and foreign real property taxes; State and local personal property taxes; State, local, and foreign income, war profits, and excess profits taxes; and State and local sales taxes are not allowed (sec. 56(b)(1)(A)(ii)).
12. Medical expenses are allowed only to the extent they exceed ten percent of the taxpayer's adjusted gross income (sec. 56(b)(1)(B)).
13. Interest deductions on a home equity loan and on a second residence which is not a house, apartment, condominium, mobile home not used on a transient basis are not allowed (sec. 56(b)(1)(C) and (e)).
14. The standard deduction and personal exemptions are not allowed (sec. 56(b)(1)(E)).
15. The amount allowable as a deduction for circulation expenditures are capitalized and amortized over a three-year period (sec. 56(b)(2)).
16. The amount allowable as a deduction for research and experimentation expenditures from passive activities are capitalized and amortized over a 10-year period (sec. 56(b)(2)).
17. The regular tax rules relating to incentive stock options do not apply (sec. 56(b)(3)).

Other rules

The taxpayer's AMT net operating loss deduction cannot reduce the taxpayer's AMTI by more than 90 percent of the AMTI determined without the net operating loss deduction (sec. 56(a)(4) and (d)). The taxpayer's AMT foreign tax credit may offset the entire minimum tax (sec. 59(a)).

For taxable years beginning before January 1, 2006, the nonrefundable personal credits (i.e., the dependent care credit, the credit for the elderly and disabled, the adoption credit, the child tax credit,³ the credit for interest on certain home mortgages, the HOPE Scholarship and Lifetime Learning credits, the saver's credit, and the D.C. homebuyer's credit) are allowed to the extent of the entire amount of the individual's regular tax and alternative minimum tax (sec. 26).

For taxable years beginning after December 31, 2005, the nonrefundable personal credits (other than the adoption credit, child credit and saver's credit) 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). The adoption credit, child credit, and saver's credit are allowed to the full extent of the individual's regular tax (reduced by the other nonrefundable personal credits) and alternative minimum tax (sec. 26).

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

³ A portion of the child credit may be refundable.

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 (sec. 53).

B. Legislative Background

The Tax Equity and Fiscal Responsibility Act of 1982 enacted the first comprehensive individual AMT.⁴ According to the legislative history of that Act, “the committee has amended the present minimum tax provisions applying to individuals with one overriding objective: no taxpayer with substantial economic income should be able to avoid all tax liability by using exclusions, deductions, and credits.”⁵ The AMT provisions enacted in 1982 are the foundation for the present law individual AMT. Under the 1982 Act, in computing AMTI, the deduction for state and local taxes, the deduction for personal exemptions, the standard deduction, and the deduction for interest on home equity loans and certain second residences were not allowed. Incentive stock option gain was included in AMTI. These remain the principal preferences and adjustments under present law. A rate of 20 percent applied to AMTI in excess of an exemption amount of \$40,000 (\$30,000 for unmarried taxpayers). The exemption amounts were not indexed for inflation, even though the regular rates were scheduled to be indexed for inflation in future years. Nonrefundable credits (other than the foreign tax credit) were not allowed against the AMT.

The Tax Reform Act of 1986 largely retained the structure of the prior-law AMT, except that deferral preferences were properly adjusted over time (and a minimum tax credit was added). Preferences were added for interest on private activity bonds and for appreciation on charitable contributions (later repealed). The tax rate was increased from 20 percent to 21 percent, and the exemption amount was phased-out for individuals with AMTI in excess of \$150,000 (\$112,500 for unmarried taxpayers). The prior-law preferences were retained. Net operating losses were allowed to offset only 90 percent of AMTI and the foreign tax credit was not allowed to reduce the tentative minimum tax by more than 90 percent.

Since 1986, several changes have been made to the computation of the individual AMT. The principal changes are set forth below:

Preferences.—The principal changes made in the determination of AMTI were to repeal the preference for charitable contributions of appreciated property; repeal the preference for percentage depletion on oil and gas wells; substantially reduce the preference for intangible drilling expenses; repeal the requirement that alternative depreciation lives be used in computing the deduction for ACRS depreciation.

Rates.—The Omnibus Budget Reconciliation Act of 1990 increased the individual AMT tax rate from 21 percent to 24 percent (when the maximum regular tax rate was increased from 28 percent to 31 percent) and the rate was further increased by the Omnibus Budget Reconciliation Act of 1993 to the 26- and 28-percent rate structure of present law (when the maximum regular tax rate was increased from 31 percent to 39.6 percent).

⁴ An add-on minimum tax was first enacted by the Tax Reform Act of 1969. That tax was repealed by the 1982 Act.

⁵ Tax Equity and Fiscal Responsibility Act of 1982, S. Rpt. No. 97-494 Vol. 1, at 108 (July 12, 1982).

The Revenue Reconciliation Act of 1997 conformed the AMT capital gain rates to the lower capital gain rates adopted for the regular tax. The Jobs and Growth Tax Relief Reconciliation Act of 2003 conformed the AMT rates for dividends to the lower rates adopted for the regular tax.

Exemption amounts.—The Omnibus Budget Reconciliation Act of 1993 increased the AMT exemption amounts to \$45,000 (\$33,750 for unmarried taxpayers). The AMT exemption amounts were temporarily increased by the Economic Growth and Tax Relief Reconciliation Act of 2001 to \$49,000 (\$35,750 for unmarried individuals) for 2001 and 2002 and further increased to \$58,000 (\$40,250 for unmarried individuals) for 2003, 2004 by the Jobs and Growth Tax Relief Reconciliation Act of 2003. These amounts were extended to 2005 by the Working Families Tax Relief Act of 2004.

Credits.—For 1998 and subsequent years, the nonrefundable personal credits have been allowed on a temporary basis to offset the AMT. The last extension, through 2005, was enacted by the Working Families Tax Relief Act of 2004. The Economic Growth and Tax Relief Reconciliation Act of 2001 provided that the child tax credit, the adoption credit, and the saver's credit may offset the AMT (subject to the sunset provisions of that Act). The American Jobs Creation Act of 2004 provided that beginning in 2005, the foreign tax credit may offset the entire the entire tentative minimum tax.

II. DATA AND DISCUSSION OF ISSUES

A. Data

Data on taxpayers affected by the AMT

A taxpayer has an alternative minimum tax liability only when his or her tentative minimum tax exceeds his regular tax liability. However, under present law, for taxable years after 2005, nonrefundable personal credits may not reduce regular tax liability below the tentative minimum tax. Thus, a taxpayer may be affected by the AMT without technically having an AMT liability if the taxpayer's regular tax exceeds the tentative minimum tax by an amount that is less than the credits. In this case, the taxpayer may reduce his or her regular tax liability to the tentative minimum tax amount, but cannot use the full amount of credits because the credits cannot be used to reduce tax liability below that of the tentative minimum tax.

Table 1 presents projected data on individual taxpayers affected by the individual AMT.⁶ These data show that there will be a sharp increase in the number of taxpayers affected by the AMT in 2006. The principal reason for this increase is that, beginning in 2006, the AMT exemption levels revert to the levels in effect prior to 2001 and certain nonrefundable personal credits are no longer allowed against the AMT. The number of taxpayers affected by the AMT continues to rise through 2010 as a result of the fact that the AMT exemption levels are not indexed for inflation while the regular income tax is indexed for inflation. By 2010, over 20 percent of individual income tax returns will have AMT liability and/or restricted use of credits totaling approximately \$110 billion. The number of taxpayers affected by the AMT declines in 2011 as a result of the expiration of the provisions of EGTRRA. The expiration of EGTRRA raises regular income tax liability and thus causes fewer taxpayers to be affected by the AMT. After a one-time decline in the number of taxpayers affected by the AMT in 2011, the number will resume rising because the AMT is not indexed for inflation.

⁶ The tables in this pamphlet define taxpayers affected by the AMT as those who have an AMT liability or who have restricted use of credits as a result of the AMT. There are some other ways in which taxpayers can be affected by the AMT that do not show up in this definition. For example, some taxpayers may choose to itemize deductions, even when the standard deduction would be higher, because certain itemized deductions are allowed on the AMT while the standard deduction is not. Such a taxpayer could then have a regular tax liability in excess of their AMT liability and not show up in the tables as a return "affected by the AMT," even though in the absence of the AMT they would have chosen to take the standard deduction in order to further reduce their tax liability.

Table 1.—Projected Individual Income Tax Returns Affected by the Individual Alternative Minimum Tax, 2005-2015

Year	Number of filed returns affected by AMT (millions)	Percentage of filed returns affected by AMT	Excess of AMT liability over regular tax liability and amount of restricted credits (\$ billions)
2005	3.6	2.7	20.7
2006	19.0	13.9	57.0
2007	21.5	15.6	66.0
2008	24.1	17.3	81.4
2009	26.5	18.8	91.8
2010	29.0	20.4	109.6
2011	14.8	10.3	41.5
2012	16.8	11.5	47.1
2013	19.0	12.9	54.2
2014	21.7	14.6	62.4
2015	24.4	16.2	70.4

Source: Joint Committee on Taxation staff estimates.

Tables 2 and 3, below, show the projected distribution of individual taxpayers affected by the AMT for 2005 and 2006, respectively. While the \$200,000 and over income category is most heavily affected by the AMT, those with the highest incomes within this category tend not to be affected by the AMT since most of their income is taxed at the highest rate under the regular income tax, 35 percent, which exceeds the rates imposed under the AMT and thus such taxpayers tend to have a regular tax liability that exceeds their AMT liability.

Tables 2 and 3 demonstrate that the individual AMT will affect an increasing number of middle-income taxpayers beginning in 2006. As noted above, the principal reason for this increase is the reversion of the AMT exemption levels to the levels in effect prior to 2001 and the disallowance of certain nonrefundable personal credits against the AMT. Also, while the decline in the AMT exemption levels will initially cause substantially more taxpayers to be affected by the AMT, more middle-income taxpayers will gradually be affected by the AMT with each passing year because the AMT exemption levels are not indexed for inflation while the regular income tax generally is indexed for inflation.

**Table 2.—Distribution of Individual Taxpayers Affected
by the AMT Under Present Law, 2005**

Income category ⁽¹⁾	Number of filed returns affected by the AMT (thousands)	Taxpayers affected by the AMT as a percentage of all taxpayers in income category	Taxpayers affected by the AMT as a percentage of all taxpayers affected by the AMT
Less than \$10,000	(2)	(3)	(3)
\$10,000 to less than \$20,000	(2)	(3)	(3)
\$20,000 to less than \$30,000	1	(3)	(3)
\$30,000 to less than \$40,000	(2)	(3)	(3)
\$40,000 to less than \$50,000	2	(3)	(3)
\$50,000 to less than \$75,000	49	(3)	1.4
\$75,000 to less than \$100,000	110	0.8	3.1
\$100,000 to less than \$200,000	1,086	6.6	30.5
\$200,000 and over	2,316	56.4	65.0
Total (all income categories)	3,566	2.9	100.0

⁽¹⁾ The income concept used to place tax returns into income categories is adjusted gross income 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 2005 levels. Excludes individuals who are dependents of other taxpayers and taxpayers with negative income, resulting in differences with Table 1.

⁽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 staff estimates.

**Table 3.—Distribution of Individual Taxpayers Affected by the AMT
Under Present Law, 2006**

Income category⁽¹⁾	Number of filed returns affected by the AMT (thousands)	Taxpayers affected by the AMT as a percentage of all taxpayers in income category	Taxpayers affected by the AMT as a percentage of all taxpayers affected by the AMT
Less than \$10,000	1	(3)	(3)
\$10,000 to less than \$20,000	(2)	(3)	(3)
\$20,000 to less than \$30,000	3	(3)	(3)
\$30,000 to less than \$40,000	19	(3)	(3)
\$40,000 to less than \$50,000	146	1.1	.8
\$50,000 to less than \$75,000	981	4.2	5.2
\$75,000 to less than \$100,000	2,693	18.4	14.2
\$100,000 to less than \$200,000	11,349	62.6	59.9
\$200,000 and over	3,763	84.1	19.9
Total (all income categories)	18,955	15.1	100.0

⁽¹⁾ Same income concept as used in Table 2, measured at 2006 levels. Excludes individuals who are dependents of other taxpayers and taxpayers with negative income, resulting in differences with Table 1.

⁽²⁾ Less than 500,000.

⁽³⁾ Less than 0.5 percent.

Details may not add due to rounding.

Source: Joint Committee on Taxation staff estimates.

Table 4, below, shows the characteristics of returns affected by the AMT, while Table 5, below, shows the effect that various proposals would have on the number of taxpayers affected by the AMT. The two tables together show that the primary reason taxpayers are affected by the AMT is the differing treatment of the State and local tax deduction and the personal exemptions for the AMT tax base as compared to the regular income tax base. Table 5 also shows that extending the higher exemption level for the AMT in effect in 2005 to 2006 would reduce the returns affected by the AMT from 19 million to just over 5 million.

Table 4.—Characteristics of Tax Returns Affected by the AMT, 2006

Returns with:	Percentage of all AMT Returns
Personal exemptions	100.0
Itemized deduction for State and local taxes	81.2
Reduced nonrefundable credits	24.3
Miscellaneous itemized deductions	21.4
Standard deduction	18.1
Passive gain or loss	2.8
All other preferences	3.4

Source: Joint Committee on Taxation staff estimates.

Table 5.—Projected Individual Income Tax Returns Affected by the AMT Under Various Proposals, 2006

Proposal:	Returns affected by AMT 2006 (millions)
Retain present law	19.0
Extend higher AMT exemption levels through 2006	5.1
Extend nonrefundable personal credits through 2006	17.8
Allow personal exemptions against the AMT	5.4
Allow State and local tax deduction in the AMT	8.4
Allow standard deduction in the AMT	14.9

Source: Joint Committee on Taxation staff estimates.

B. Discussion of Issues

In general

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.

Equity

The AMT results in a higher tax liability for certain taxpayers than would be the case if only the regular income tax 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 appear to have the ability to pay taxes do pay taxes as a result of the AMT, 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 1982 and 1986 was the perception 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 tax-exempt private activity 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. 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 taxes (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. To the extent that individuals affected by the AMT have business-related income, 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 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 equalize 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 view 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. However, 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 after-tax compensation from working (labor income is taxed) and saving (investment income is taxed). Thus, 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.⁷ 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 deductions. If labor income is measured identically under the regular income tax and the AMT, then any distortions in labor supply are altered if a taxpayer subject to the AMT has a different marginal tax rate under the AMT than he or she would have under the regular tax. The AMT has statutory marginal tax rates of 26 or 28 percent. However, those with alternative minimum taxable income in the phaseout range of the exemption level (\$150,000 to

⁷ 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.

\$382,000 for married taxpayers filing jointly and \$112,500 to \$273,500 for unmarried individuals) will have an effective marginal tax rate of 33 and 35 percent respectively. In general, for 2005, taxpayers affected by the AMT are likely to have statutory regular tax rates in the 25 to 35 percent range,⁸ and thus in general it may be the case that taxpayers affected by the AMT generally do not experience a marginal tax rate that is much different than they would have faced on the regular tax. To the extent this is true, the AMT is not likely to have a significant impact on labor supply distortions relative to the regular income tax. Under present law, however, over time many more lower-income taxpayers with regular income tax rates of 15 percent will be affected by the AMT, causing their marginal tax rate to rise to at least 26 percent, thus likely exacerbating labor supply distortions.

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

⁸ Taxpayers paying under the regular tax are also often subject to various phaseouts of credits, deductions, and other benefits that raise effective marginal tax rates above these statutory rates. See, for example, Joint Committee on Taxation, *Present Law and Analysis Relating to Individual Effective Marginal Tax Rates* (JCS-3-98), February 3, 1998.

AMT rather than the regular tax has been modest in comparison to aggregate investment in the United States.

Because of the increasing number of taxpayers 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.

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. However, some might argue that the availability and widespread use of tax preparation software substantially reduces the compliance burdens of the AMT. Others argue that a tax system should not be so complex as to effectively require the use of software or paid return preparers to prepare returns.

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. Table 1, above, indicates that many more individuals will become affected by the AMT in the future.

In order to reduce the burden of the individual alternative 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 phaseout of the minimum tax exemption could be eliminated, the nonrefundable personal credits could be allowed to offset the minimum tax after 2005; or the alternative minimum tax could be repealed.