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ALTERNATIVE MINIMUM TAX

Overview of Its Rationale and Impact on Individual Taxpayers

Statement of James R. White
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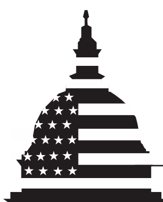

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Chairman Grassley, Ranking Member Baucus and Members of the Committee

I am pleased to participate in the Committee's hearing on family tax relief. My statement focuses on the Alternative Minimum Tax (AMT), its interaction with the regular tax system, and its projected growth in coverage. In summary, my statement makes the following points:

- AMT was designed to ensure that high-income individuals do not avoid significant income tax liabilities--for tax year 1997, about 14,000 taxpayers would not have paid any income taxes absent AMT.
- AMT operates as a separate tax system that parallels the regular individual income tax system but with different rules for determining taxable income, different tax rates for computing tax liability, and different rules for allowing the use of tax credits.
- AMT affected about 1 percent of taxpayers in 2000 and accounted for about $5.8 billion in additional tax revenue; by 2010, it is expected to increase the tax liabilities of about one out of six taxpayers and account for about $189 billion in tax revenues over the period.
- The projected increase in AMT coverage is, for the most part, attributable to inflation (the regular tax system is indexed for inflation, but the AMT is not) and to the scheduled expiration of legislation temporarily excluding some tax credits (such as child tax credits) from AMT rules.
- AMT's impacts include increased taxpayer compliance burden; increased IRS administrative cost; redistribution of the tax burden among taxpayers; changed economic incentives; and the potential to neutralize, for some taxpayers, changes to the tax system.

My testimony today is based on our August 2000 report to the Committee.[1]

RATIONALE FOR ESTABLISHING AMT

AMT was created to reduce the ability of high-income individuals to escape payment of tax on income by using tax preferences available under the regular tax system. A type of minimum tax was first enacted in 1969, following congressional testimony by the Secretary of the Treasury reporting that 155 individuals, each with adjusted gross income above $200,000 (about $1.1 million in fiscal year 2000 dollars), paid no federal income tax in 1966.

Over the intervening years, the minimum tax has been amended a number of times, producing today's AMT. Although the mechanics of AMT were periodically modified, the objective of limiting high-income taxpayers' ability to avoid significant tax liability by using tax preferences was retained.[2] According to recent IRS calculations, about 14,000 taxpayers would not have had any individual income tax liability absent AMT in tax year 1997.

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[1] See *Alternative Minimum Tax: An Overview of Its Rationale and Impact on Individual Taxpayers* (GAO/GGD-00-180, Aug. 15, 2000).
[2] See S. Rept. No. 313, 99th Cong., 2d sess., p.520.

HOW AMT WORKS

In general, AMT is a separate tax system that parallels the regular individual income tax system. It generates an alternative tax liability by

- applying different tax rates to a broader base of income than the regular individual income tax system does and
- limiting the use of certain tax credits available under the regular income tax.

As illustrated in figure 1, taxpayers complete a series of steps to determine if they are affected by AMT.[3]

First, Taxpayers Calculate Their Regular Tax Liability.

As the first step in the process, taxpayers calculate their tax liability based on their taxable income under the regular income tax. To determine taxable income,[4] taxpayers add up their various items of income, such as salaries, interest, and dividends, and then

- subtract certain allowable items, such as moving expenses and alimony, to compute Adjusted Gross Income (AGI);[5]
- subtract the standard or itemized deductions, such as home mortgage interest,[6] and
- subtract personal exemptions.[7]

Next, taxpayers determine their regular tax liability by applying the appropriate tax rates to this taxable income amount. The regular individual income tax has five marginal tax rates: 15 percent, 28 percent, 31 percent, 36 percent, and 39.6 percent for tax year 2000.[8] The regular income tax also provides special tax rates for long-term capital gains.

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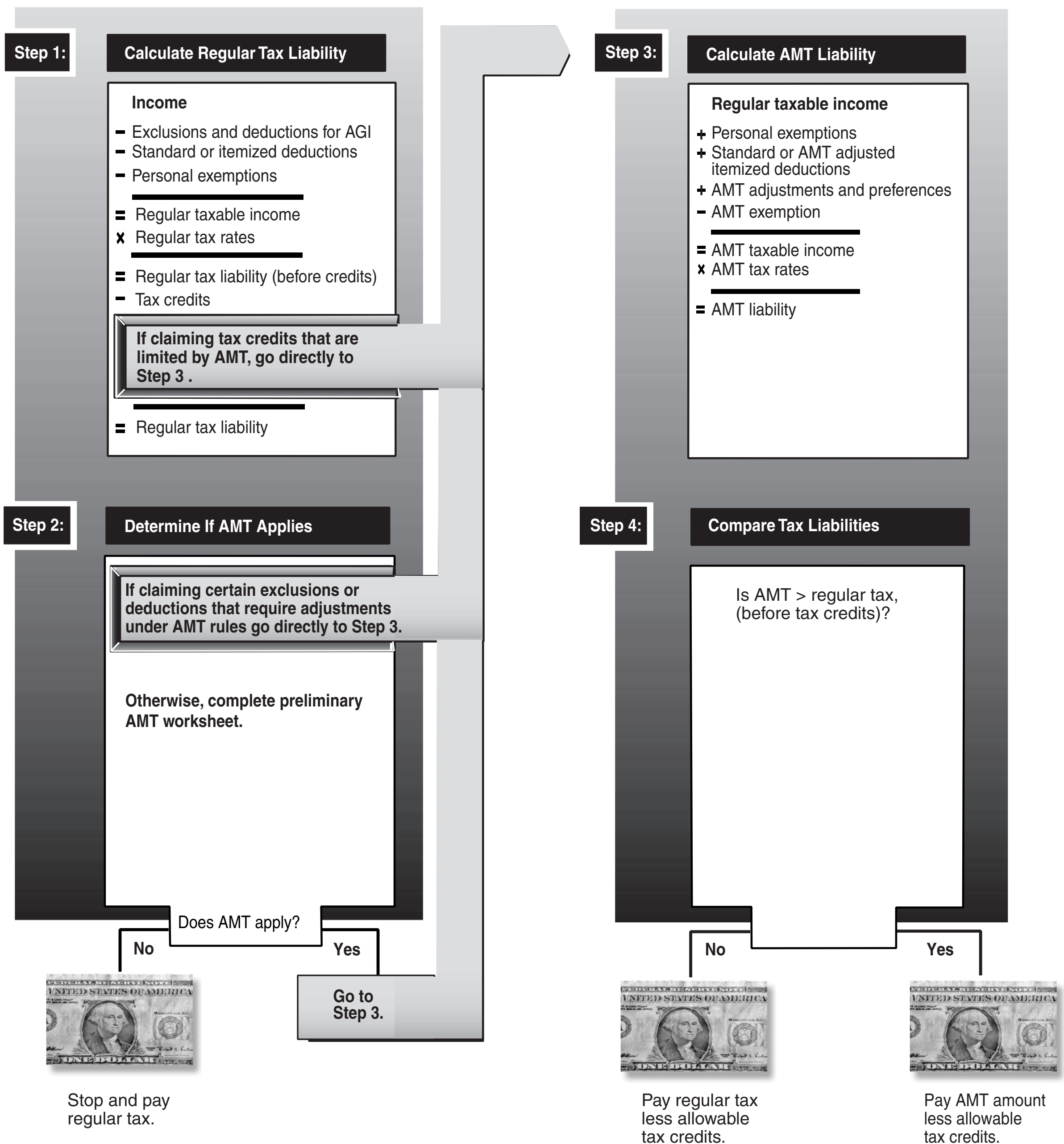
[3] This illustration generally applies to individual taxpayers required to file IRS Form 1040, U.S. Individual Income Tax Return. See appendix I for a few illustrations on how individual taxpayers may have their taxes increased by AMT in 2000.
[4] Generally, all income is subject to tax; however, some types of income are excluded, such as interest on tax-exempt bonds.
[5] Deductions for determining AGI are certain items that are specifically exempt or excluded from gross income by statute, such as the deduction for IRA contributions, moving expenses, and alimony.
[6] In 2000, the standard deduction was $4,400 for single filers; $6,450 for heads of household; $7,350 for married, filing jointly; $3,675 for married, filing separately.
[7] Personal exemptions are based on the number of dependents claimed by a taxpayer. In 2000, personal exemptions were $2,800 for each qualifying exemption, subject to phase-outs based on taxpayer income.
[8] In computing a taxpayer's tax liability, the tax rates are applied to varying levels of taxpayer income according to the taxpayer's filing status. For example, the tax for married taxpayers filing jointly is 15 percent of the first $43,850 in taxable income; $6,577.50 plus 28 percent of taxable income between $43,850 and$105,950; $23,965.50 plus 31 percent of taxable income between $105,950 and $161,450; $41,170.50 plus 36 percent of taxable income between $161,450 and $288,350; and $86,854.50 plus 39.6 percent of taxable income over $288,350.

Figure 1: Simplified Illustration of Regular Income Tax and AMT



Source: GAO Analysis.

Last, taxpayers may reduce their regular tax liability with certain tax credits unless limited by AMT rules. Taxpayers with credits limited by AMT, such as the low income housing tax credit, are required to go to step 3 in figure 1, bypassing step 2, in order to determine the extent to which AMT limits apply. Under current law, taxpayers generally may not use certain tax credits, most notably the general business credit, to reduce their regular tax liability to an amount less than their AMT. For such taxpayers, AMT serves as a floor for the regular income tax below which allowable credits are disallowed but may

be carried over to another tax year. Under current law, however, personal tax credits, such as the child and education credits, are not limited by AMT rules through 2001. However, beginning in 2002, taxpayer use of these credits to reduce their tax liability would be limited by AMT.

Second, Taxpayers Determine Whether AMT Applies

As the second step, taxpayers determine whether they may be subject to AMT as follows.

- Taxpayers who claim certain AMT preference items under the regular income tax that are considered AMT adjustments or preferences (for example, percentage depletion or intangible drilling costs) are automatically subject to the AMT rules and are to proceed directly to step 3—calculate AMT liability.[9]
- Other taxpayers are to complete a worksheet that contains a series of income tests designed to determine whether a taxpayer's income exceeds a preliminary threshold according to the basic AMT rules.[10]

If the worksheet shows that their income exceeds the threshold, taxpayers must continue to step 3—calculate AMT liability. If the worksheet shows that their income does not exceed the threshold, taxpayers pay their regular tax liability without having to complete steps 3 and 4 in figure 1.

Third, Some Taxpayers Calculate AMT Liability

As the third step, taxpayers subject to AMT compute their AMT liability using the AMT form,[11] which requires them to recalculate their taxable income and tax liability using rules that differ from the regular income tax rules. To calculate taxable income under AMT, taxpayers essentially start with the taxable income amount reported under the regular system and then do the following:

Add back their personal exemptions that were allowed under the regular income tax.

Add back the standard or certain AMT-adjusted itemized deductions that were allowed under the regular income tax. AMT requires taxpayers to adjust certain itemized deductions taken under the regular income tax. For example, AMT disallows the deduction for state and local taxes and allows only for the deduction of medical expenses above 10 percent of AGI.[12] However, AMT does not disallow or adjust all

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[9] See appendix I of GAO/GGD-00-180, Aug. 15, 2000. The appendix identifies the items that automatically subject taxpayers to the AMT rules in step 2 of figure 1.
[10] The worksheet is provided in the instructions to IRS forms 1040 and 1040A.
[11] The AMT form is IRS Form 6251, the Alternative Minimum Tax-Individuals. This form, when necessary, is to be attached to IRS Form 1040, U.S. Individual Income Tax Return.
[12] Under the regular income tax, deductions are allowed for medical expenses in excess of 7.5 percent of AGI.

itemized deductions. For example, AMT does not require taxpayers to add back certain mortgage interest or charitable contribution deductions to their taxable income.[13]

Add other, non-itemized, AMT adjustments and preference items taken under the regular income tax. AMT disallows certain non-itemized preference items and requires adjustments to other non-itemized deductions available under the regular income tax, including some income excluded from the regular income tax. Many of these items are related to timing of deductions allowed for certain types of business investments. In effect, the elimination or adjustment of certain preference items expands the base of taxable income under AMT.[14]

Subtract the AMT exemption amount based on filing status. The AMT exemption amount ($45,000 for joint filers), is generally intended to replace the personal exemptions and the standard deduction allowed under the regular income tax. The AMT exemption is subject to a phase out based on taxpayer income[15] and is not adjusted to account for family size.

Taxpayers then calculate their AMT liability by applying the AMT tax rates to their AMT taxable income. The AMT applies a 26-percent tax rate on the first $175,000 of AMT taxable income and 28 percent of such income in excess of $175,000.[16]

Fourth, Taxpayers Compare Tax Liabilities and Check the Use of Certain Tax Credits

As the fourth step, taxpayers essentially compare their regular tax liability (before credits) with their AMT liability, as shown in step 4 of figure 1. In general, if their AMT liability is greater than their regular tax liability (before credits), they must pay their AMT liability less any allowable credits. If their AMT liability is less than their regular tax liability (before credits), they pay their regular tax liability less any allowable credits.[17]

Currently, the AMT rules temporarily allow taxpayers to use personal credits without limitation.[18] However, taxpayers generally may not use general business credits to reduce their regular tax liability to an amount less than their tax liability computed under the AMT rules. Also, taxpayers whose AMT liability exceeds their regular tax liability may

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[13] See appendix I of GAO/GGD-00-180, Aug. 15, 2000 for more details.
[14] Ibid.
[15] The $45,000 exemption amount is subject to a phase-out of 25 percent of AMT taxable income in excess of $150,000. The AMT exemption for single and head of household filers is $33,750, subject to a phase-out of 25 percent for taxable income in excess of $112,500. The AMT exemption amount for married individuals filing separately is $22,500, subject to a phase-out of 25 percent of taxable income in excess of $75,000.
[16] For married taxpayers filing separately, AMT applies the 26-percent tax rate to the first $87,500 of AMT taxable income and the 28-percent rate on the excess. AMT also has special rules for taxing capital gains income, which generally preserve the lower capital gains tax rates of the regular tax system (e.g., 20-percent tax rate).
[17] The foreign tax credit can also be deducted from AMT., but it may not reduce AMT by more than 90 percent. Additionally, taxpayers may be able to use part of their AMT liability, if applicable, to offset their regular tax liability in the following year. Commonly referred to as the "AMT credit," this credit is subject to restrictive conditions, and few taxpayers are eligible for it.
[18] The Omnibus Consolidated and Emergency Supplemental Appropriations Act of 1998 allowed taxpayers to claim their personal credits—including the child and education credits—in full against their AMT liability for the tax year beginning after December 31, 1997. The Ticket to Work and Work Incentives Improvement Act of 1999 extended that provision through 2001.

not use certain refundable tax credits (e.g., the earned income tax credit) to reduce their AMT liability to an amount less than their tax liability computed under the regular tax.

PROJECTED INCREASES IN AMT COVERAGE AND TAX LIABILITY

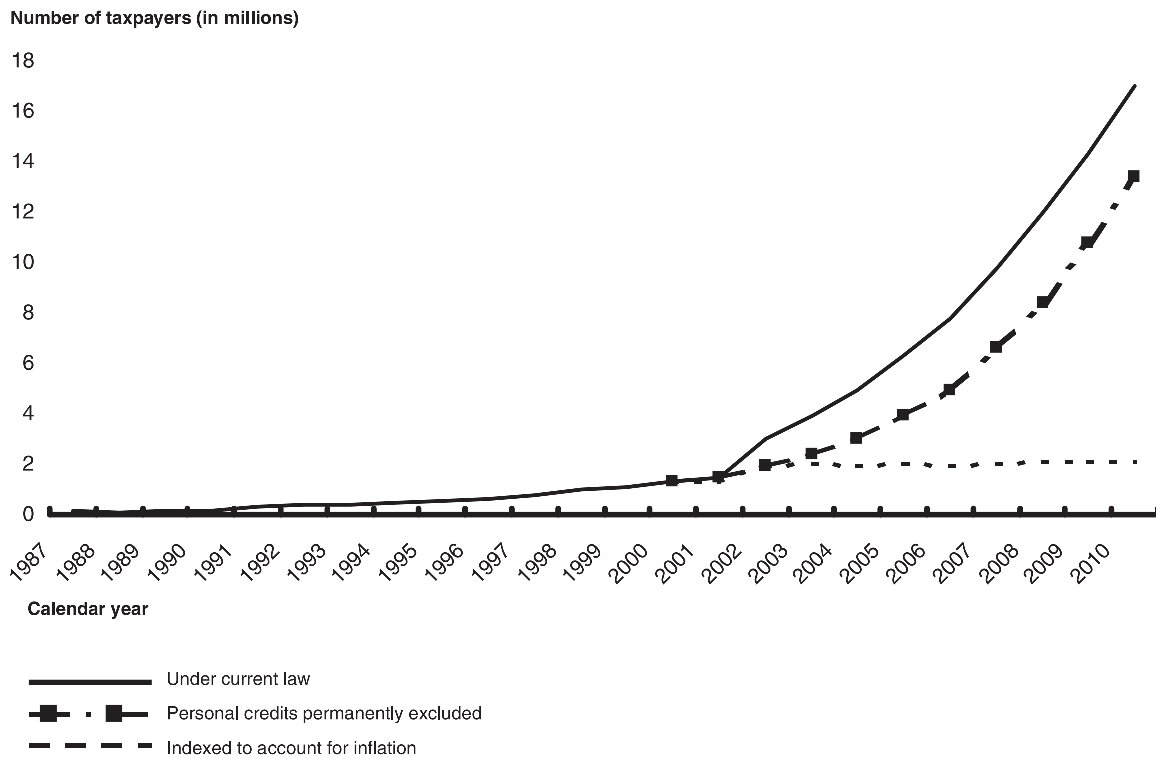
Currently, according to recent research at Joint Committee on Taxation (JCT) and Treasury, AMT affects relatively few taxpayers and generates a relatively small portion of additional tax liability.[19] For 2000, Treasury research indicates that about 1.3 million taxpayers—about 1.3 percent of all taxable returns—would have to remit more in tax than they would otherwise. Their additional tax liability was estimated at about $5.8 billion.

By 2010, however, AMT coverage and tax liabilities are projected to increase dramatically. (See fig. 2 for trends.) Recent research at Treasury estimated that:

- The number of taxpayers affected by AMT under current law is projected to expand from about 1.3 million in 2000 to about 17 million in 2010—a 31 percent average increase per year. By 2010, AMT is expected to affect 16 percent of all taxable returns filed by individuals, up from about 1.3 percent in 2000.
- The corresponding additional AMT liability is projected to increase from about $5.8 billion to about $38.2 billion from 2000 to 2010--a 21 percent average increase per year--for a total increase of $189 billion over this period.

[19] For reporting purposes, we used data estimates from recent research conducted at the Department of the Treasury's Office of Tax Analysis. See Robert Rebelein and Jerry Tempalski, *Who Pays the Individual AMT?*, Office of Tax Analysis Working Paper 87 (June 2000). All estimates in this paper were made using the Treasury Department's Individual Tax Model in combination with the administration's economic forecast from the FY 2001 Budget. This working paper notes that the views expressed in the paper do not necessarily represent official Treasury positions. Accordingly, we limited our use of the paper to the data produced by the Treasury models and refer to the working paper as recent research at Treasury. Also, JCT provided us with updated tables from its report, *Present Law and Background Relating to the Marriage Tax Penalty, Education Tax Incentives, the Alternative Minimum Tax, and Expiring Tax Provisions* (JCX-39-99).

Figure 2: Actual and Projected Number of Taxpayers Affected Financially by AMT



Source: Department of the Treasury, Office of Tax Analysis Working Paper 87 (June 2000)

The additional tax liability generated by AMT has two components.

- The additional tax liability generated from individuals with direct AMT liabilities is projected to increase from $3.4 billion in 2000 to $26.4 billion in 2010. The number of affected individuals is projected to increase from 1.2 million in 2000 to 12.5 million in 2010.

- The additional tax liability generated from individuals with credits lost due to AMT is projected to increase from $2.4 billion in 2000 to $11.8 billion in 2010. The number of individuals affected by the loss of credits is projected to increase from 200,000 in 2000 to 9.4 million in 2010. Of this increase, about 4.9 million of the 9.4 million taxpayers were expected to incur both a direct AMT tax liability and a reduction in their ability to use tax credits.

REASONS FOR THE AMT INCREASES

The projected increase in AMT coverage is, for the most part, attributable to inflation (the regular tax system is indexed for inflation but the AMT is not) and to the scheduled expiration of legislation temporarily excluding some tax credits (such as child tax credits) from AMT rules.

AMT Is Not Indexed for Inflation

In the regular income tax system, the personal exemptions, standard deduction, and tax rate brackets increase based on inflation. Under AMT, however, the exemption amounts, the threshold phase-out amounts for these exemption amounts, and the AMT rate brackets remain constant.

The lack of inflation indexing in AMT causes taxpayers' AMT liabilities to increase faster than their regular tax liabilities. Real income growth—growth above inflation—will increase both regular tax and AMT liabilities. However, under the regular tax system, income growth due to inflation will generally not increase regular tax liabilities as a percentage of income because income is increasing at the same rate, but it will increase AMT liabilities as a percentage of income. The result is that over time, more taxpayers will have an AMT liability that exceeds their regular tax liability as long as there is inflation.

If the AMT parameters were indexed to account for inflation starting in 2000, according to recent research at Treasury (illustrated in fig. 2), the projected number of taxpayers affected financially by AMT over time would be relatively constant and significantly less than under current law.[20] The number of individuals affected by an inflation-adjusted AMT is estimated at 2.1 million in 2010 compared to 17 million under current law.

Increases Attributable to Expiration of Tax Credit Legislation

In 2001, legislation that was enacted to temporarily exclude personal credits from limitation under the AMT rules is scheduled to expire.[21] Recent research at Treasury estimated that the number of taxpayers with reduced credits would increase from 200,000 in 2001 (the last year of the personal credits exclusion) to 2 million in 2002 and would rise to 9.4 million in 2010. According to JCT, the recently enacted child and education credits are expected to be affected the most.[22]

If personal tax credits were permanently excluded from the AMT rules, the projected number of taxpayers affected financially by AMT and the corresponding revenue generated would also be lower than under current law.[23] As figure 2 shows, recent research at Treasury estimated that under this scenario, about 13.4 million taxpayers would be affected by AMT in 2010 compared to 17 million under current law.

AMT HAS A NUMBER OF IMPACTS

AMT has a number of impacts, including increased compliance burden on taxpayers; increased administrative costs on IRS; redistribution of the tax burden among taxpayers; changed economic incentives in the tax system; and the potential to neutralize, for some

[20] Under this scenario, personal tax credits would be limited by the AMT rules beginning in 2002.
[21] See footnote 18.
[22] The Child Credit, the HOPE education credit, and the Lifetime Learning Credit are provisions of the regular income tax that were enacted in the Taxpayer Relief Act of 1997.
[23] This scenario does not include inflation adjustments for the AMT parameters.

taxpayers, changes to the tax system. The projected growth in AMT coverage would amplify these impacts.

Taxpayer Compliance Burden

Although it is difficult to concretely measure compliance burden, there is common agreement that AMT can significantly complicate the filing situation for taxpayers. The National Taxpayer Advocate ranks AMT as one of the most burdensome areas of tax law.[24]

A significant portion of AMT compliance burden is attributable to the complexity of the AMT rules. AMT requires taxpayers to compute their regular tax liability and then recompute their AMT liability using a different base of income, different exemptions, and different tax rates. AMT also applies different treatments to certain income deductions, exclusions, and credits that may be used by taxpayers under the regular income tax. As a result, affected taxpayers are required to apply two methods of accounting to some of these items–one for the regular tax and one for AMT.

According to IRS and Treasury officials, the complexity of calculating AMT liability can be most problematic for married taxpayers who consider filing separately. AMT, like the regular tax, establishes procedures that are intended to minimize or eliminate that ability of some taxpayers to allocate income arbitrarily between spouses to reduce their tax liability. If married taxpayers were to follow all recommended procedures, they would have to compute their taxes four different ways. First, they would need to compute their regular tax as if they were filing jointly and then again as if filing separately. Then they would need to determine their AMT tax as if filing jointly and then again as if they were filing separately. From these computations, the taxpayers could then determine which filing method would be most appropriate for them.

IRS Administrative Costs

The complexity of AMT and increases in the number of taxpayers affected also would complicate IRS' efforts to administer the federal tax system. According to IRS, AMT is more than just an add-on to the existing tax system. AMT involves much more than just annually processing the AMT returns filed by taxpayers such as computer-checking calculations on the returns and crediting the taxpayers' accounts with the payments. Some aspects of compliance with AMT rules can be verified only through office or field audits. According to IRS, the frontline employees who do such verification work consistently rank AMT as one of the most complex provisions with which they deal.

Redistribution of Tax Burden

As shown in figures 3 and 4, recent research at Treasury indicated that AMT coverage, absent any legislative change, will shift from mostly higher income taxpayers in 2000 to increasingly more middle-income taxpayers by 2010.

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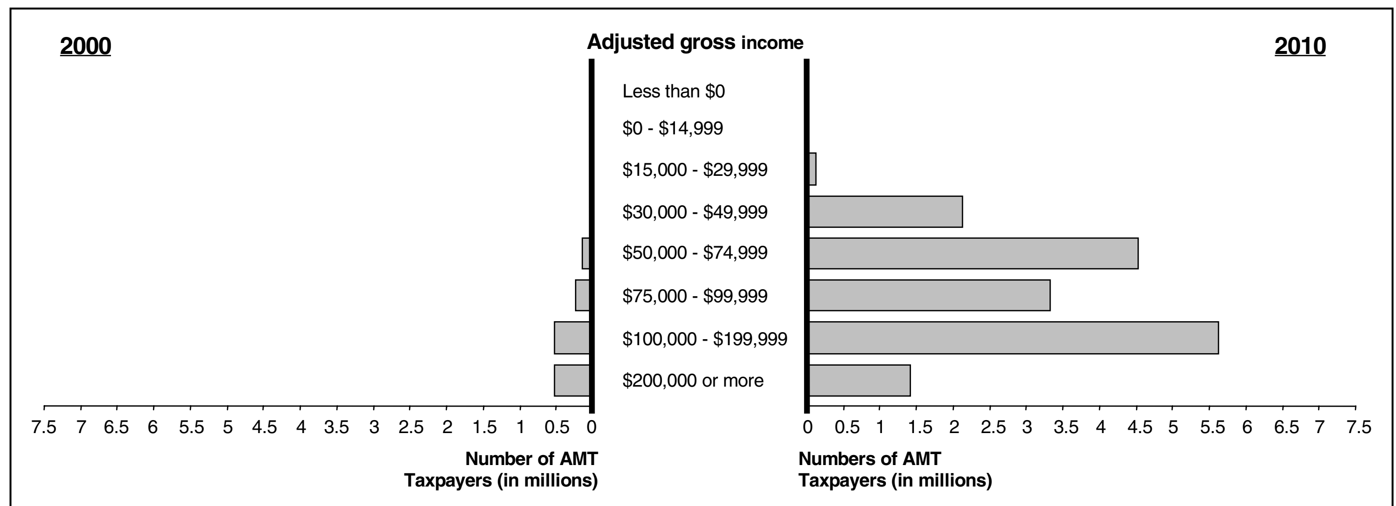
[24] FY 1999 National Taxpayer Advocate's Annual Report to Congress, IRS Publication 2104 (Rev.12-99).

The recent research at Treasury provides some additional insight into the shift in the classes of taxpayers affected by AMT. In 2000, the taxpayers projected to be affected by AMT are more likely to be higher income families with many dependents. By 2010, increasingly more middle-income, moderately sized families are expected to be affected by AMT. For example, the percentage of taxpayers affected by AMT with incomes between $50,000 and $75,000 and four personal exemptions is projected to increase from about 1 percent in 2000 to 32 percent in 2010. The primary reason for this change is that for middle income taxpayers, personal exemptions are projected to be the largest and most common items to be added back into taxable income under AMT.

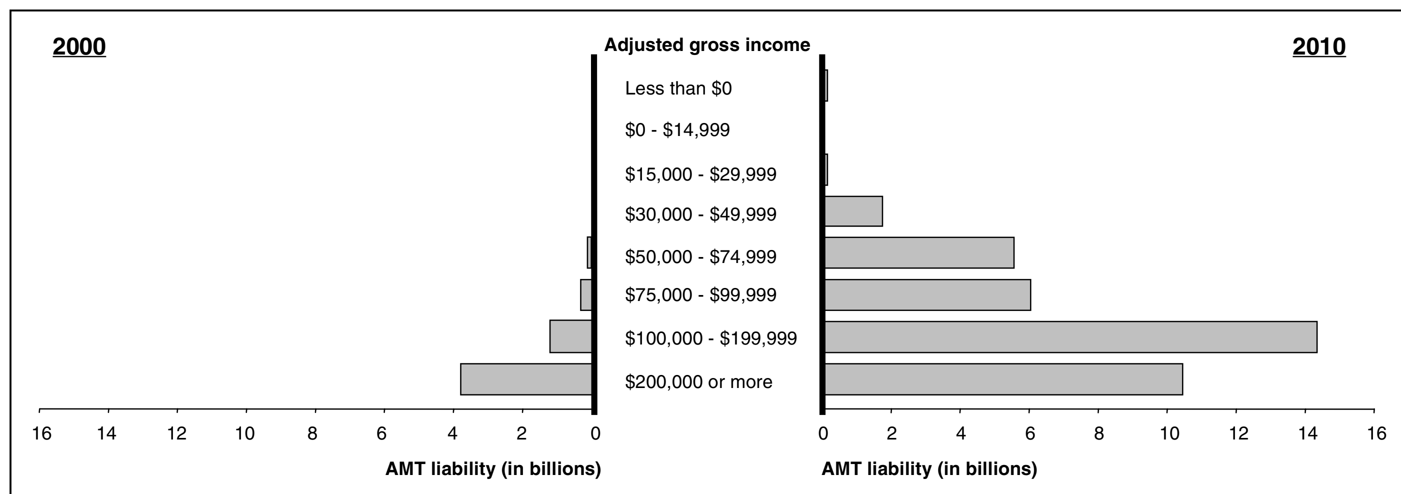
Additionally, the state where a taxpayer lives also affects AMT coverage. The projections indicate that taxpayers living in states with high income and property taxes are more likely to be affected by AMT than those in states with low income and property taxes. The apparent driving factor for this change is that state and local taxes are projected to amount to about one-half of the total preference items that are added back into the taxable income for computing AMT tax liability in 2010. (See app. II for additional information on the proportion of AMT taxpayers by state of residence.)

Figure 3: Distribution of the Number of Taxpayers Financially Affected by AMT



Note: Adjusted gross income is in constant 2000 dollars.
Source: Department of the Treasury, Office of Tax Analysis Working Paper 87 (June 2000)

Figure 4: Distribution of the Additional AMT Tax Liability



Note: Adjusted gross income is in constant 2000 dollars.
Source: Department of the Treasury, Office of Tax Analysis Working Paper 87 (June 2000)

Changed Economic Incentives

Through its different definition of taxable income and tax rate structure, AMT may affect the economic incentives created by the regular income tax.[25] If AMT coverage increases over the next 10 years as projected, more taxpayers will face those affected incentives. Two examples follow.

- According to JCT, AMT adjustments, preference items, and credit limitations may reduce incentives for taxpayers to undertake certain investments and activities that are favored under the regular tax. For example, unincorporated business owners' incentives to invest may be reduced because AMT rules regarding depreciation are less generous than under the regular tax. Also, if education credits become limited by AMT because the moratorium on the use of personal credits expires, taxpayers may have less incentive to pursue educational opportunities that qualify for these credits.

- Additionally, the current 26- and 28-percent tax rates under AMT are generally lower than the tax rates a taxpayer faces under the regular tax. Lower marginal tax rates—the additional tax owed from earning an additional dollar of income—decrease the disincentives taxpayers face to work additional hours or invest additional amounts. The extent to which the incentives and disincentives affected by AMT lead to changes in taxpayer behavior and changes in overall economic performance is uncertain.

[25] For discussions of the effects of AMT on economic efficiency, see Joint Committee on Taxation, Present Law and Issues Relating to the Individual Alternative Minimum Tax ("AMT") (JCX-3-98), Feb.2, 1998, and Michael J. Graetz and Emil Sunley, "Minimum Taxes and Comprehensive Tax Reform," in Henry J. Aaron, Harvey Galper, and Joseph A. Pechman, eds., Uneasy Compromise: Problems of a Hybrid Income-Consumption Tax (Washington, D.C.: The Brookings Institution, 1988).

Impact on Changes to the Regular Tax

For some taxpayers, AMT has the potential to neutralize future tax changes designed to provide tax relief in the regular tax system. As I mentioned before, AMT is a parallel tax system that imposes higher taxes on taxpayers who have higher AMT liabilities than regular tax liabilities. Thus, taxpayers who are already subject to AMT would not benefit from reductions in their regular income tax.[26]

Additionally, some taxpayers who pay the regular tax may not receive the full benefits of cuts in their regular tax. Tax reduction legislation could reduce the taxes for some individuals below the level of taxes that would be due under AMT rules.

This concludes my statement. I would be pleased to take any questions you may have.

[26] Similarly, tax changes that increase regular taxes would not affect those AMT taxpayers whose AMT liability already exceeded the regular tax increase.

Appendix I

Illustrations Depicting How Individual Taxpayers May Have Their Taxes Increased by AMT in 2000[27]

Illustration 1: A large family (husband, wife, and six children) had wage earnings of $80,000 in 2000. In filing their 2000 tax return, the family would not benefit from itemizing deductions because they rented a house and had no other significant tax deductions. The family was eligible to take the standard deduction, personal exemptions, and child tax credit. Under the regular income tax, the family's tax liability would be $5,377 ($8,377 in income tax less a $3,000 child tax credit), or about 11 percent of their $50,250 taxable income ($80,000 in wages less the standard deduction of $7,350 and personal exemptions of $22,400).

Under current tax law, AMT would cause this family's tax liability to increase 13 percent above its tax liability under the regular income tax. After computing AMT, the family's tax liability would be $6,100 ($9,100 in taxes less $3,000 child tax credit). The $9,100 tax liability results from AMT tax rules that require the family to recompute taxable income (essentially add back the standard deduction and personal exemptions to taxable income computed under the regular tax), then reduce that taxable income by a $45,000 exemption amount and then apply a 26-percent tax rate to the remainder.

Illustration 2: A retired couple, age 65, received taxable pension income totaling $80,000, interest and dividends of $10,000, and distributed capital gains totaling $125,000 from mutual fund investment in technology stocks in 2000. In filing their 2000 tax return, the couple would not benefit from itemizing deductions because they had paid off the mortgage on their house and had no other significant deductions. Under the regular income tax, the couple's tax liability would be $40,685 or about 20 percent of their $201,358 taxable income ($80,000 in taxable pension income, $10,000 interest and dividends, and $125,000 in capital gains less a standard deduction of $9,050 and personal exemptions of $4,592).

Under current tax law, AMT would cause this couple's tax liability to increase about 1 percent above its tax liability under the regular income tax. After computing AMT, the couple's tax liability would be about $40,925. The $40,925 tax liability results from AMT tax rules that require the couple to recompute taxable income (essentially, add back the standard deduction and personal exemptions to taxable income computed under the regular tax), then reducing that amount by a $45,000 exemption amount (adjusted down to $28,750 because of the extent to which the couple's income exceeded the applicable $150,000 threshold for full use of the exemption). To this residual amount, AMT provides for applying a 20-percent rate to income attributable to capital gains and 26 percent to the remainder.

[27] These illustrations are based on three hypothetical taxpayers. The extent to which AMT affects any individual taxpayer depends on the taxpayer's unique characteristics.

Illustration 3: A four-member family (husband, wife, and two children) had income totaling $265,000 in 2000, comprised of wage earnings totaling $190,000, interest and dividend earnings of $17,000, and long-term capital gains of $58,000. Given the nature of the family's expenditures, the family would benefit from itemizing their deductions when filing their 2000 tax return. Their itemized deductions would include $23,000 for state and local income taxes and property taxes, $16,000 for home mortgage interest, and $6,000 for charitable gifts. Additionally, they are eligible to deduct $4,704 for personal exemptions. Given the amount of their income, the regular tax rules limit the family's itemized deductions and personal exemptions to $45,622. Under the regular income tax, the family's tax liability would be $52,748, or about 24 percent of its taxable income of $219,378.

Under current tax law, AMT would cause this family's tax liability to increase about 2 percent above its tax liability under the regular income tax. Under AMT rules, the family's tax liability would be about $54,045 on income of $221,250 (alternative minimum taxable income of $243,000 less a $45,000 exemption amount reduced to $21,750 because of the extent to which family income exceeded the applicable $150,000 threshold for full use of the exemption). Under AMT rules, a 20-percent rate was then applied to income attributable to capital gains and 26 percent to the remainder.

Appendix II

AMT Taxpayers and State of Residence

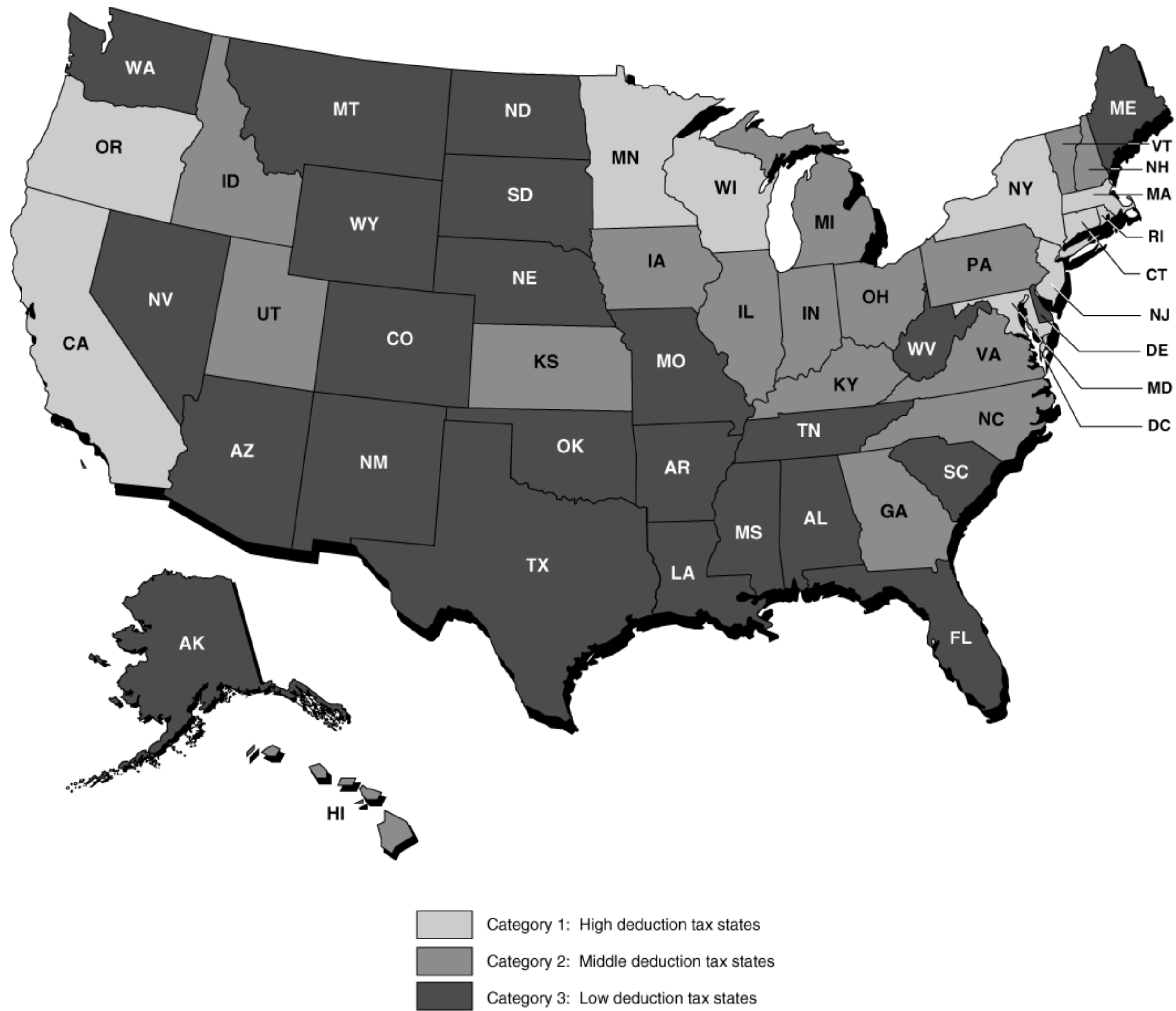
Under the regular income tax, but not AMT, taxpayers who itemize deductions are allowed to reduce their tax liability by deducting from their income the amounts paid to state and local governments for property and income taxes. States vary in their reliance on different types of taxes. For example, some rely heavily on sales taxes, which are not deductible under the regular or AMT, while others rely heavily on income or property taxes, which are deductible under the regular tax but not AMT.

In recent research at Treasury, an analysis was done to determine the effect that the payment of state and local income and property taxes had on the payment of AMT. States were ranked on the basis of the average state and local tax deductions (analyzed as a percentage of income) that were taken by taxpayers who itemized deductions and who would continue to itemize if state and local tax deductions were eliminated. The states were then grouped into three categories so that the number of taxpayers who reside in the states in each category would account for approximately one-third of the total number of taxpayers.

The research at Treasury indicated that, holding other factors constant, AMT taxpayers are more likely to live in states that rely more heavily on taxes that are deductible in determining tax liability under the regular income tax. In the Treasury research it was estimated that, in 2000, 58 percent of taxpayers affected by AMT lived in high tax deduction states, 24 percent lived in middle tax deduction states and 18 percent lived in low tax deduction states. The estimates showed that by 2010, 45 percent of taxpayers affected by AMT would live in the high tax deduction states, 32 percent would live in middle tax deduction states, and 22 percent would live in low tax deduction states.[28] The breakout of states according to the working paper's categorization is shown in figure 5.

[28] The decline was attributed to the increasing affect of another AMT provision, i.e., personal exemptions as discussed in the section on the redistribution of the tax burden.

Figure 5: States categorized by Deductibility of Their Taxes Under Federal Income Tax Law



Source: Department of the Treasury, Office of Tax Analysis Working Paper 87 (June 2000)

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