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THE INDIVIDUAL AMT: WHY IT MATTERS

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Abstract *- The individual alternative minimum tax (AMT) is a complicated tax that currently affects relatively few taxpayers (700,000 in 1997) and raises relatively little revenue ($4.5 billion in 1997). By 2007, however, the number of AMT taxpayers will reach 9 million and their AMT liability will reach $21 billion. The reason for these very sharp increases is that the main parameters (e.g., personal exemption and rate bracket widths) of the regular income tax are indexed for inflation, whereas the main parameters (e.g., AMT exemption) of the AMT are not. This paper discusses the structure of the individual AMT and examines the long-run effects of the AMT.*

The individual alternative minimum tax (AMT) is not well understood by most taxpayers. This lack of understanding is not surprising, given that relatively few taxpayers (500,000 in 1994) pay AMT tax, and those that do pay relatively little in AMT taxes (about $3.6 billion in 1994).[1]

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The individual AMT is a complicated tax that was primarily intended to affect the relatively few high-income taxpayers who Congress believed overused certain tax deductions, exclusions, or credits and consequently were not paying their fair share of taxes. The AMT was not intended to affect many taxpayers. Unless the tax code is changed, however, by 2007, over 9 million taxpayers will be affected by the AMT, and these taxpayers will pay about $21 billion in AMT tax. The taxpayers affected by the AMT in the future will increasingly be taxpayers who are not traditionally viewed as aggressive and abusive of the system.

The reason for the projected sharp increase in the number of AMT taxpayers is that the main parameters (i.e., personal exemption, standard deduction, and tax-bracket widths) of the regular tax are indexed for inflation, whereas the main parameters of the AMT are not. Each year, inflation puts more taxpayers onto the AMT. As a result, if policymakers change the tax code to limit growth in AMT liability, the cost will be quite large.

This paper begins by describing the evolution of the individual minimum tax. Then, it describes the structure of the

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current AMT and the taxpayers affected by it. It concludes with a discussion of AMT projections for the next ten years.

EVOLUTION OF THE INDIVIDUAL MINIMUM TAX

The tax code has had two different individual minimum taxes—the "add-on" minimum tax, which was in effect from 1970 to 1982, and the AMT, which has been in effect since 1979.[2] Changes to the individual minimum tax have been included in almost every major tax bill since 1969 and in many minor tax bills. The changes have generally been designed to increase the likelihood that all taxpayers with significant amounts of economic income incur their fair share of federal tax liability.

Changes to the regular tax system can also play an important role in determining the effect of the minimum tax. Because the minimum tax is designed to affect taxpayers with relatively low regular tax liability, the more regular tax liability that a taxpayer has for a given level of income, the less minimum tax liability that taxpayer is likely to have. For example, an increase in current regular tax rates would reduce both the amount of AMT liability and the number of taxpayers affected by the AMT, absent any change to the AMT itself.

Add-on Minimum Tax

The add-on minimum tax was enacted following the furor that resulted from release of a Treasury study in January 1969.[3] The study, the first of its kind, reported that 155 individuals, each with adjusted gross income (AGI) of more than $200,000, paid no federal income tax in 1966.

The add-on minimum tax was a tax on "tax preferences," which are items excluded from taxable income under the regular tax but taxable under the minimum tax. The most important of these tax preferences was excluded capital gains.

Congress significantly expanded the add-on minimum tax in 1976, because it was concerned that the tax was not adequately forcing high-income taxpayers to pay their fair share. Part of this concern followed release of another Treasury study that found that 244 taxpayers with AGIs above $200,000 in 1974 had no federal income tax liability that year.[4]

The add-on minimum tax was weakened in 1978, because Congress was concerned that the 1976 changes to the tax were hampering capital formation. In particular, Congress eliminated excluded capital gains as an add-on preference in 1978, because it was concerned that capital gains were taxed too heavily. As a replacement, the AMT was created, and excluded capital gains were taxed under the AMT.

The add-on minimum tax was repealed in 1982, and nearly all of its preference items were folded into the AMT.

AMT

When the AMT was created in 1978, it originally had only two preference items, of which excluded capital gains was almost certainly the more important. The list of AMT preferences was expanded substantially in 1982, both because the add-on minimum tax preferences were folded in and because many new preferences were added.

The AMT was changed significantly again in 1986. But the 1986 tax change with the biggest effect on the AMT was the elimination of the capital gains

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exclusion under the regular tax. Excluded capital gains accounted for the vast majority of pre-1987 AMT preferences, about 85 percent in 1986.

The most recent major changes to the AMT occurred in the Omnibus Reconciliation Act of 1990 (OBRA90) and the Omnibus Reconciliation Act of 1993 (OBRA93). OBRA90 increased the AMT tax rate from 21 to 24 percent. OBRA93 increased the AMT tax rate and made it graduated at 26 and 28 percent. OBRA93 also increased the AMT exemptions by 12.5 percent.

CURRENT AMT

The individual AMT can be considered a parallel tax system to the regular tax system. Like the regular tax, the AMT involves multiplying some measure of income by the appropriate tax rate, then subtracting allowable tax credits. But the AMT uses a separate tax calculation from the regular tax, with a generally broader tax base, lower tax rates, higher exemption, and fewer allowable credits. Further, as noted above, unlike the regular tax, the key AMT parameters (i.e., exemption level and rate brackets) are not indexed for inflation.

A taxpayer's AMT liability is essentially the difference between a taxpayer's regular income tax liability and the taxpayer's tentative AMT.[5] Tentative AMT is calculated using AMT income, the AMT exemption, AMT rates, and allowable AMT credits.

AMT Income

A taxpayer's tentative AMT is based on the amount of AMT income (AMTI) that exceeds the AMT exemption. The AMTI is calculated by taking line 35 of Form 1040 (taxable income plus personal exemptions), then adding the many AMT preference items. Although most AMT preferences increase AMTI relative to taxable income, some (e.g., state and local tax refunds) actually decrease AMTI relative to taxable income.

The 1994 AMT form included lines for 27 different preferences[6] (Table 1). Most preferences are deferral items, which accelerate deductions or delay realization of income, but which do not cause a permanent difference in taxable income over a period of years. For example, the AMT uses a depreciation schedule than generally requires longer write-offs than the regular tax, and the AMT requires that research and experimental expenses be amortized over ten years rather than expensed as the regular tax allows.[7] The remaining AMT preferences are exclusion items that permanently lower taxable income. For example, the AMT includes the standard deduction and certain tax-exempt interest as preferences.

For taxpayers who incurred AMT liability in 1994, four items accounted for 86 percent of total AMT preferences (including personal exemptions). State and local tax deductions accounted for 47 percent, miscellaneous deductions above the 2 percent floor for 19 percent, personal exemptions for 11 percent, and post-1986 depreciation for 9 percent. The only other preference that accounted for more than five percent of total adjustments was passive activity losses. Table 1 lists the amounts of all AMT preferences and other items needed to reconcile AMT income with taxable income for 1994.

In addition to AMT preferences increasing AMT income above taxable income, the AMT also has different rules than the regular tax for deducting net operating losses (NOLs). These different rules generally increase AMT income

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TABLE 1
RECONCILIATION OF TAXABLE INCOME WITH AMT INCOME FOR
TAX RETURNS AFFECTED BY THE AMT IN 1994

	Reported Amount ($ Millions)	Number of Returns (in Thousands)	Average Amount per Return (in Dollars)	Deferral Preference
I. Taxable income from Form 1040	71,929	464	155,019	
II. Reconciliation of AMT with Form 1040 taxable income				
A. Adjustments and preferences from AMT form (Form 6251)				
1 State and local tax deductions	10,039	402	24,973	
2 Miscellaneous deductions above the two-percent floor	4,050	213	19,014	
3 Post-1986 depreciation	2,011	125	16,088	x
4 Passive activity loss	1,269	129	9,837	x
5 Incentive stock options	928	7	132,571	x
6 Long-term contracts	446	6	74,333	x
7 Charitable donations	231	15	15,400	
8 Beneficiaries of estates	228	24	9,500	x
9 Standard deduction	216	58	3,724	
10 Private activity bonds interest	186	31	6,000	
11 Depletion	140	10	14,000	
12 Loss limitations	123	5	24,600	x
13 Medical deductions	83	37	2,243	
14 Certain home-mortgage interest	68	8	8,500	
15 Circulation expenses	44	[a]		x
16 Intangible drilling costs	41	3	13,667	x
17 Pre-1987 accelerated depreciation	30	7	4,286	x
18 Related adjustments	12	5	2,400	x
19 Tax shelter farm loss	4	1	4,000	x
20 Mining costs	1	[a]		x
21 Patron's adjustment	1	[a]		x
22 Pollution control facilities	[b]	[a]		x
23 Installment sales	–2	[a]		x
24 R&E expenditures	–4	[a]		x
25 Investment interest	–6	6	–1,000	
26 Adjusted gain or loss	–483	41	–11,780	x
27 State and local tax refunds	–656	195	–3,364	
Subtotal (adjustments and preferences)	19,000	463	41,037	
B. Other reconciliation items				
28 Regular tax NOLs	7,303	13	561,769	
29 Personal exemptions	2,394	276	8,674	
30 Limitation on itemized deductions under regular tax	–1,703	252	–6,758	
31 AMT NOLs	–1,860	5	–372,000	
32 Undetermined reconciliation items	182			
Subtotal (other reconciliation items)	6,316			
Total Reconciliation Items:	25,316	464	54,560	
III. AMT income (taxable income plus reconciliation items)	97,245	464	209,580	

Source: Tabulations from unpublished IRS data from the Statistics of Income Division.
[a]Less than 500.
[b]Less than $500,000.

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relative to taxable income. The AMT form does not call the difference in NOL rules an AMT preference.

The AMT exemption is $45,000 for joint returns ($33,750 for singles); the exemption is not indexed nor is it based on the number of dependents. The AMT exemption is phased out at the rate of $0.25 per $1 of AMTI above $150,000 for joint returns ($112,500 for singles). Thus, the AMT exemption is totally eliminated for joint returns with AMTI above $330,000 ($247,500 for singles).

AMT Tax Rate

The AMT tax rate is 26 percent on the first $175,000 of AMTI above the AMT exemption and 28 percent on AMTI more than $175,000 above the exemption. For taxpayers in the phase-out range of the AMT exemption, the 26- and 28-percent tax rates effectively increase to 32.5 and 35 percent, respectively.

Allowable Credits Against the AMT

The only major tax credit that can be used against the AMT is the foreign tax credit.[8] But the amount of foreign tax credits that can be used against the AMT is generally limited to 90 percent of a taxpayer's precredit tentative AMT.

In 1994, 160,000 taxpayers had tax credits disallowed because of the AMT; the amount of these disallowed tax credits was $1.3 billion.[9] Of these lost credits, $0.9 billion were AMT credits (discussed below). The vast majority of the other lost credits were general business credits (GBCs).[10] The remaining lost credits totaled less than $50 million.[11]

AMT Credits

Some taxpayers who incur AMT liability may be able to use some of their AMT liability as a credit to offset their regular tax liability in future years. These AMT credits, however, cannot lower a taxpayer's regular tax liability for a given year below the taxpayer's tentative AMT for that year.

Only AMT liability that results from deferral preferences can offset future regular tax liability.[12] The portion of AMT liability that results from exclusion preferences cannot be used to offset future regular tax liability. (Table 1 indicates which AMT preferences are deferral preferences.) The rationale behind the AMT credit is to allow taxpayers with tax preferences that reflect deferral, rather than permanent avoidance of tax liability, some adjustment after the deferral period ends.[13]

Taxpayers incurred $9.0 billion in individual AMT liability (excluding lost credits) over the 1987–93 period, but they used only $1.8 billion of AMT credits over the 1988–94 period. Taxpayers used $0.4 billion in AMT credits in 1994 (Table 2). Taxpayers also carried forward an additional $1.5 billion in unused AMT credits from pre-1994 AMT liability into 1995. Combining the credits used over the 1988–94 period with unused credits carried forward indicates that taxpayers will be able to use a maximum of $3.3 billion in AMT credits resulting from the $9.0 billion in AMT liability.

The obvious reason for the large difference between AMT liability and AMT credits is that AMT deferral preferences are a relatively small portion

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TABLE 2
HISTORICAL INDIVIDUAL MINIMUM TAX DATA

	Add-on Minimum Tax Liability[a]			Alternative Minimum Tax								
				Liability Reported on AMT Form[a]			Use of Credits Limited by AMT[b]			AMT Credits Used[a]		
Liability Year	Number of Returns with Add-on Minimum Tax Liability (in Thousands)	Add-on Minimum Tax Liability ($ Millions)	Average Add-on Minimum Tax Liability per Return ($ Thousands)	Number of Returns with AMT Liability (in Thousands)	AMT Liability ($ Millions)	Average AMT Liability per Return ($ Thousands)	Number of Returns with Credits Limited (in Thousands)	Amount of Credits Limited by AMT ($ Millions)	Average Credits Limited per Return ($ Thousands)	Number of Returns Using AMT Credits (in Thousands)	AMT Credits Used ($ Millions)	Average AMT Credits Used per Return ($ Thousands)
1970	19	122	6.4									
1971	24	168	7.1									
1972	27	216	8.1									
1973	26	182	6.9									
1974	19	143	7.7									
1975	20	144	7.1									
1976	247	1,000	4.1									
1977	399	1,323	3.3									
1978	495	1,514	3.1									
1979	74	309	4.2	153	866	5.6						
1980	95	413	4.4	123	850	6.9						
1981	126	566	4.5	137	1,261	9.2						
1982	101	451	4.4	131	1,069	8.1						
1983				265	2,521	9.5						
1984				370	4,490	12.1						
1985				428	3,792	8.9						
1986				609	6,713	11.0						
1987				140	1,675	12.0	not available					
1988				114	1,028	9.1	not available			26	203	7.7
1989				117	831	7.1	54	511	9.5	40	253	6.3
1990				132	830	6.3	72	580	8.1	34	214	6.4
1991				244	1,205	4.9	92	676	7.3	32	169	5.3
1992				287	1,357	4.7	129	881	6.8	63	284	4.5
1993				335	2,053	6.1	135	1,021	7.6	60	256	4.3
1994				369	2,233	6.1	160	1,338	8.4	77	374	4.9

[a] From various issues of IRS's *Individual Income Tax Returns*, published annually by the Statistics of Income Division.
[b] Calculated using U.S. Treasury Individual Tax Model.

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of all AMT preferences. Of the $25.3 billion in AMT adjustments in 1994, only $4.6 billion were deferral items that could generate AMT credits.

FILING COMPLICATIONS CAUSED BY THE AMT

As described above, the AMT may not sound very complicated, but it contains several features that can significantly complicate the filing of tax returns for taxpayers who owe AMT tax. In addition, the AMT complicates filling out tax returns for many other taxpayers who do not even owe AMT tax.

Dual Accounting Systems

Many AMT preferences (e.g., depreciation and circulation expenses) result from the AMT having different amortization and depreciation schedules than the regular tax. As a result, taxpayers have to keep two separate sets of accounting records for these items to determine the appropriate amount of these AMT preferences. Similarly, the AMT also has different rules than the regular tax for using NOLs and foreign tax credits. For these items, taxpayers must also keep separate accounting records.

Kiddie Tax

To determine the individual AMT liability for a child subject to the kiddie tax, a taxpayer must fill out both a 17-line worksheet and an 18-line worksheet. The child's AMT liability can be affected if part of his parents' AMT exemption is unused or if his parents' (or even a sibling's) regular tax liability is greater than their tentative AMT liability.

Claiming AMT Credits

To use AMT credits to offset regular tax liability (or to carry forward unused AMT credits), a taxpayer must fill out both the 42-line AMT form and the 28-line AMT credit form for both the current year and the previous year.

Regular Tax Credits

The AMT can significantly complicate filing a tax return for the millions of taxpayers with tax credits, even though a taxpayer may have no additional liability from the AMT. The IRS instructions for many of these credits include a 10-line worksheet that every taxpayer who claims the credit is expected to fill out to determine if the AMT disallows any of the credit. The vast majority of taxpayers do not have any disallowed credits, but they can only be assured of this after completing the worksheet (and possibly filling out the 42-line AMT form itself).

TAX LIABILITY FROM THE MINIMUM TAX

The minimum tax has never accounted for more than two percent of total individual tax liability in any year. As Table 2 shows, annual minimum tax liability has ranged between $122 million in 1970, the first year of a minimum tax, and $6.7 billion in 1986. Significant changes in annual minimum tax liability were generally caused by new legislation.

Add-on minimum tax liability was relatively stable from 1970 to 1975, then soared in 1976 because of the 1976 tax changes. Add-on minimum tax liability plunged in 1979 with the elimination of excluded capital gains as a preference item, then was relatively stable until the add-on minimum tax was eliminated after 1982.

The AMT liability was $0.9 billion in 1979, the first year of the AMT, and increased in most years until peaking in

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1986. The 1982 AMT changes significantly increased AMT liability in the 1983–86 period. The AMT liability increased dramatically from $3.8 billion in 1985 to $6.7 billion in 1986, primarily because of a huge increase in capital gains that resulted from enactment of the 1986 tax changes.[14] Taxpayers with long-term capital gains rushed to realize their capital gains in 1986 before the 60-percent exclusion was eliminated at year-end.

The end of the capital gains exclusion, by increasing regular tax liability, significantly reduced AMT liability after 1986. Increases in the AMT rate in OBRA90 and OBRA93 increased AMT liability over the 1991–94 period, but AMT liability in 1994 was still lower than in the mid-1980s (Figure 1).

TAXPAYERS WITH MINIMUM TAX LIABILITY

Not surprisingly, as Table 2 shows, the amount of minimum tax liability is generally closely related to the number of taxpayers affected by the minimum tax. The number of returns with add-on minimum tax liability ranged between 19,000 (0.03 percent of the total number of individual tax returns filed) in both 1970 and 1973 and 495,000 (0.6 percent) in 1978. The number of returns with AMT liability ranged between 114,000 (0.1 percent) in 1988 and 609,000 (0.6 percent) in 1986. Despite the AMT rate increases in 1990 and 1993, the number of AMT taxpayers in 1994 was still less than in 1986 (Figure 2).

The AMT is generally considered to be a tax paid primarily by high-income taxpayers. The data certainly support this belief. In 1994, taxpayers with AGIs above $100,000 incurred 88 percent of AMT liability. Although the distribution of AMT liability is heavily skewed to high-income taxpayers, the distribution of the number of AMT taxpayers is not so heavily skewed. In 1994, only 61 percent of the returns with AMT liability had AGIs above $100,000 (Table 3).

Taxpayers with very high AGIs account for a disproportionate share of total AMT liability. Returns with AGIs above $500,000 in 1994 accounted for only 6 percent of the total number of returns with AMT liability, yet these returns accounted for 37 percent of total AMT liability. The average AMT liability for returns with AGIs above $500,000 in 1994 was $44,100, whereas the average AMT liability for returns with AGIs below $500,000 was $5,200.

The data suggest that roughly 40 percent of taxpayers with AMT liability off the AMT form (i.e., excluding lost credits) in one year will have AMT liability in the following year. Based on panel data, 37 percent of the taxpayers in the panel who had AMT liability in 1992 also had AMT liability in 1993; 46 percent of the taxpayers who had AMT liability in 1993 also had AMT liability in 1994.[15] Overall, 65 percent of the taxpayers who had AMT liability over the 1992–4 period had AMT liability in only one of the three years, 28 percent had AMT liability in two of the three years, and only 6 percent had AMT liability in all three years.

In 1994, 18,000 taxpayers (four percent of all taxpayers with AMT liability) had no regular tax liability but did have AMT liability. These taxpayers incurred a total of $318 million in AMT liability (nine percent of total AMT liability). The average amount of AMT liability incurred by these taxpayers was $18,000 per year. The most distinguish-

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FIGURE 1. Minimum Tax Liability, 1970–94

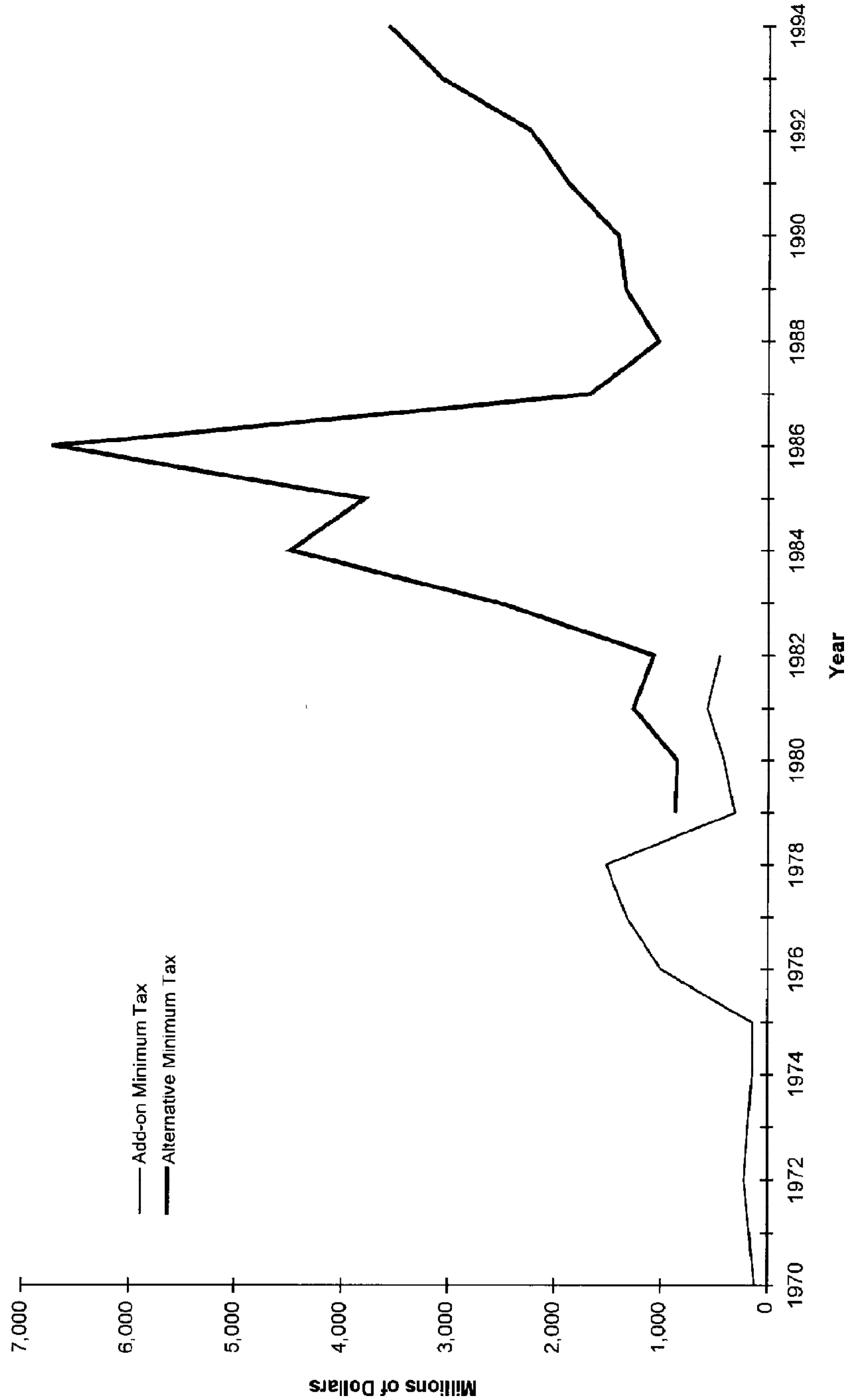

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FIGURE 2. Number of Returns with Minimum Tax Liability, 1970–94

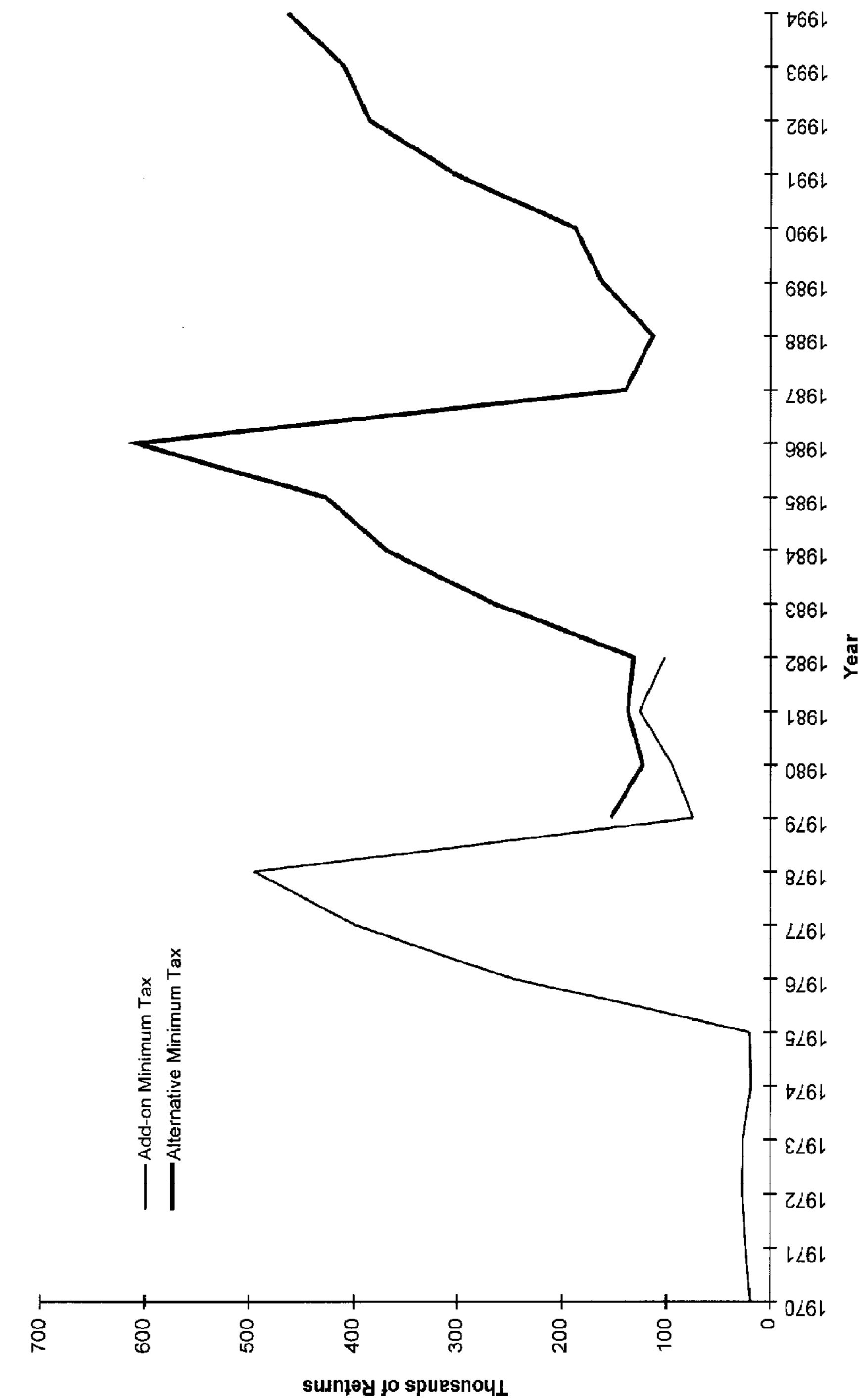

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TABLE 3
INCOME DISTRIBUTION OF INDIVIDUAL AMT, 1994

Adjusted Gross Income (in Dollars)	Returns with AMT Liability		Amount of AMT Liability	
	Number (in Thousands)	Percent of Total	$ Millions	Percent of Total
<0	3	1	102	3
0 – 10,000	26	6	17	0
10,000 – 20,000	3	1	6	0
20,000 – 30,000	5	1	12	0
30,000 – 50,000	18	4	40	1
50,000 – 75,000	57	12	70	2
75,000 – 100,000	67	14	189	5
100,000 – 200,000	147	32	705	20
200,000 – 500,000	108	23	1,115	31
>500,000	30	6	1,323	37
Total	464	100	3,579	100

Source: Treasury's Individual Tax Model.
Note: Detail may not sum to total because of rounding.

ing characteristics of these taxpayers are that together they accounted for 63 percent of all AMT NOL deductions, 33 percent of the incentive stock option preference, and 22 percent of AMT foreign tax credits used.

THE AMT UNDER PRESENT LAW OVER THE NEXT TEN YEARS

Most taxpayers see the AMT as a tax that has no impact on them. A common perception is that the AMT applies only to an elite few and can be safely ignored by the vast majority of taxpayers. However, if no change is made to present law, the AMT will affect over 9 million individual taxpayers by 2007.

Today the AMT affects relatively few individual income taxpayers. In 1997, it is projected that just under 700,000 taxpayers will be affected by the AMT.[16] These taxpayers make up fewer than 0.7 percent of all taxpayers with positive individual income tax liability in 1997. The impact of the individual AMT will broaden significantly over the next ten years unless there is a change in present law. From 1997 through 2007, the number of taxpayers with AMT liability is projected to grow at an annual rate of 29 percent. In 2007, just under 9 percent of all taxpayers with positive tax liabilities will be affected by the individual AMT. This large increase in the number of taxpayers affected by the AMT is shown in Figure 3.

Under present law, tax liability from the individual AMT also is projected to increase substantially. As shown in Figure 4, tax liability from the individual AMT revenues and lost tax credits is projected to increase to just over $21 billion by 2007. This is more than three times the amount of AMT liability in 1986, and represents a 16.5 percent average annual increase from the projected $4.5 billion in AMT liability for 1997. As a percentage of individual income tax liability, the AMT is projected to increase from 0.7 percent in 1997 to 2.1 percent in 2007.

Designed to ensure that high-income taxpayers with unusually high deductions, exemptions, and credits do not avoid paying income taxes, the AMT generally has affected few taxpayers

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FIGURE 3. Alternative Minimum Tax: Projected Number of Returns Affected, 1997–2007

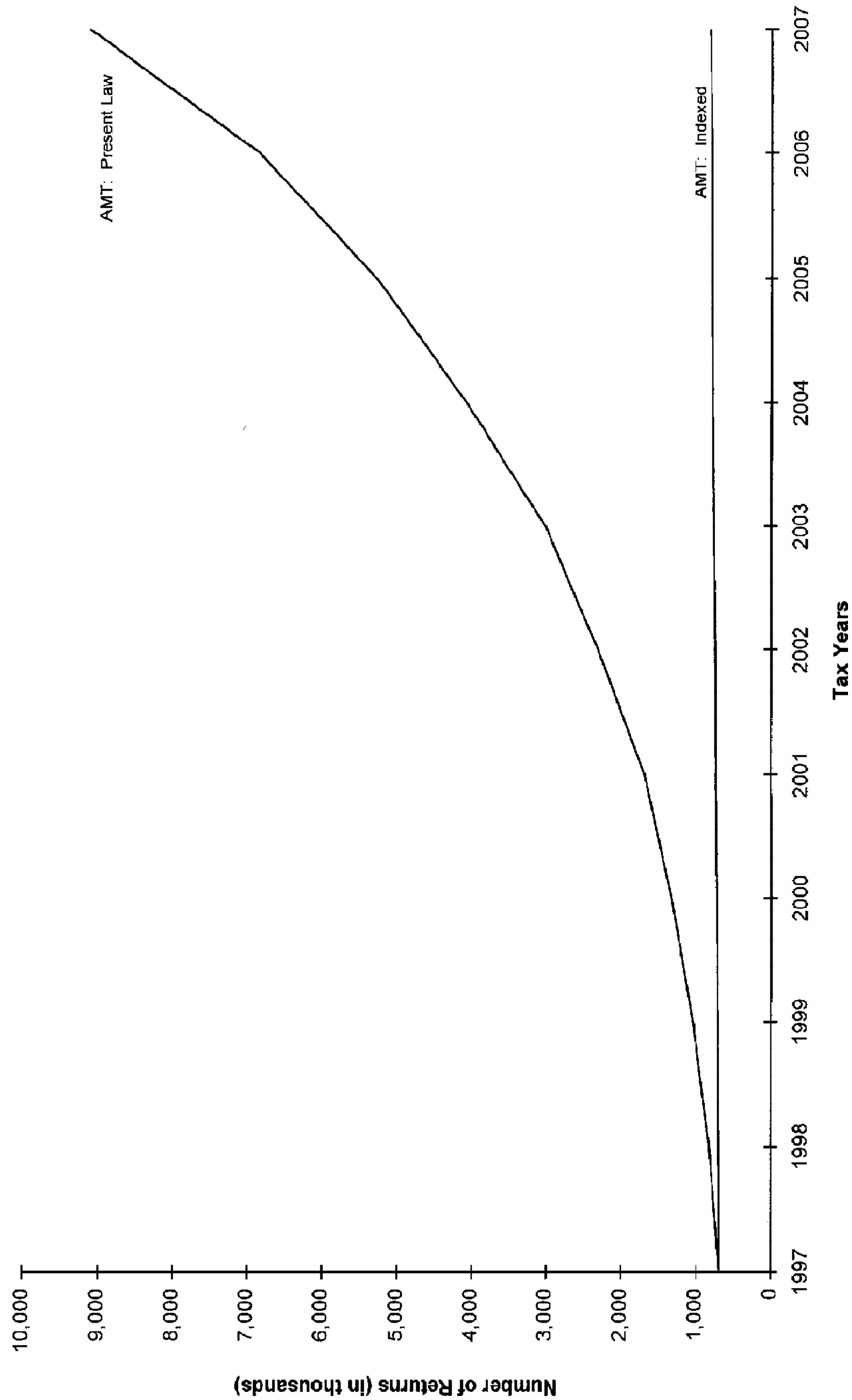

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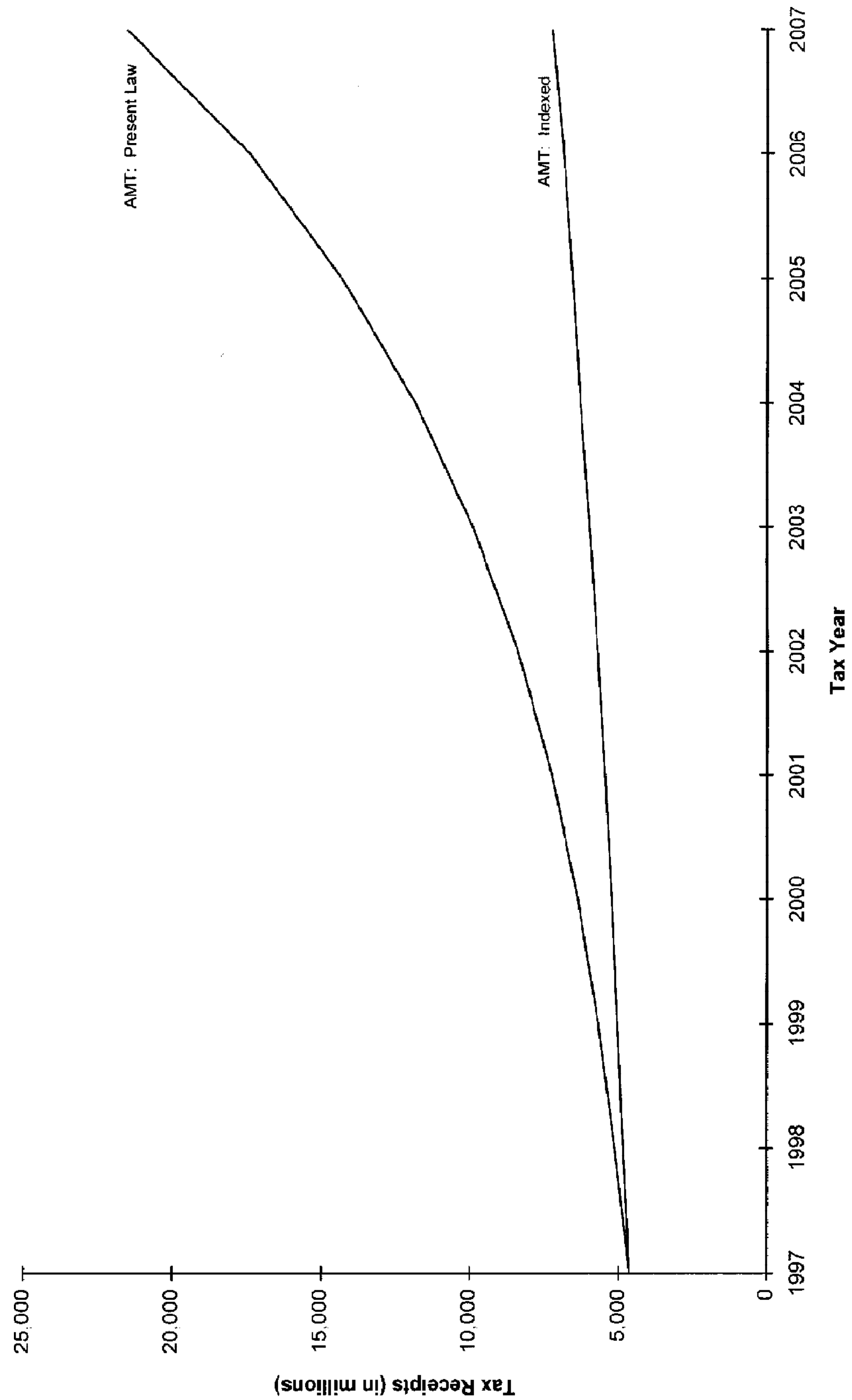
FIGURE 4. Alternative Minimum Tax: Projected Tax Revenues, 1997–2007



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with income less than $100,000. In 1997, only 0.2 percent of taxable returns reporting AGI less than $100,000 are projected to pay the AMT or to have tax credits reduced because of the AMT. By 2007, this percentage is projected to increase to 4.4 percent.[17] More than one in four taxpayers with AGI greater than $75,000 will be affected by the AMT in 2007, and nearly one in three taxpayers with AGI greater than $100,000 will be affected. Figure 5 compares the percentage of taxable returns affected by the AMT in tax year 1997 with the percentage of returns affected in tax year 2007 by AGI class. Under present law, the most dramatic rise in the share of taxpayers affected by the AMT will occur in the $75,000 to $100,000 AGI category.

A rising share of the AMT preference items of taxpayers affected by the AMT will come from the standard deduction and personal exemptions. The increase in importance of these two preference items indicates the broader range of taxpayers who will be affected by the AMT over the next ten years under present law. These two AMT preference items are projected to make up just over 13 percent of the total AMT preference items in 1997 for taxpayers affected by the AMT. This share will increase to nearly 50 percent by 2007. Today, the majority of the AMT preference items come from the personal exemption, standard deduction, state and local taxes, and miscellaneous itemized deductions. However, by 2007, these four preference items will constitute almost 95 percent of all AMT preferences. Under AMT rules, these four preference items are exclusion items that cannot generate AMT credits to be used to offset future regular tax liability. Table 4 shows the distribution of AMT preference items for taxpayers affected by the AMT in tax years 1997 and 2007. The share of total AMT preference items from the standard deduction will increase by almost sixfold over the ten-year period, increasing from 1.2 to 6.8 percent.

The Standard Deduction and the AMT

The increase in the standard deduction as a share of total AMT preference indicates that the AMT will have an impact on an increasing number of taxpayers who claim the standard deduction. Between 1997 and 2007, the number of taxpayers who claim the standard deduction and have AMT liability is projected to increase from approximately 65,000 to nearly 2.1 million. As a percentage of taxable returns claiming the standard deduction, the increase also is large. In 1997, 0.1 percent of all taxpayers with positive tax liability and claiming the standard deduction are projected to be affected by the AMT. By 2007, this percentage is expected to rise to 3.2 percent.[18]

An example may help demonstrate why so many taxpayers who take the standard deduction will be affected by the AMT in the future under present law. Consider a hypothetical family that consists of a couple with two dependents filing a joint return. Assume the couple takes the standard deduction[19] and claims the dependent care credit for each dependent.[20] The regular individual income tax, before and after tax credits, and the tentative AMT over a range of AGI levels are shown in Figure 6 for our hypothetical family for 1997. As Figure 6 shows, this family's regular income tax after credits exceeds its tentative AMT for all income levels. Therefore, the tax liability of this family would be represented by the regular-tax-after-credit curve, and the family's tax liability is unaffected by the AMT. Over the next

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FIGURE 5. Percentage of Taxable Returns Affected by the AMT by Income Class, Tax Years 1997–2007

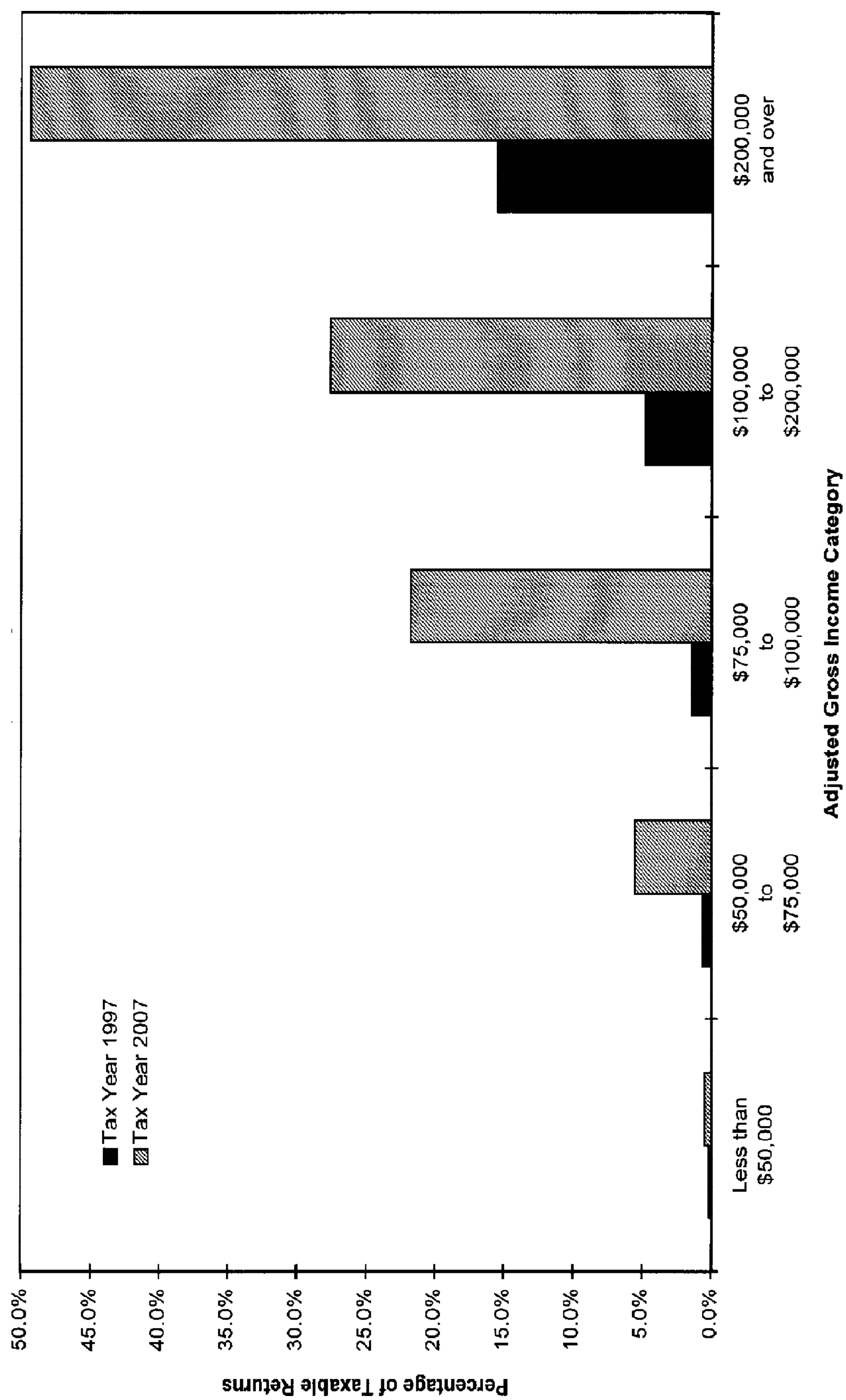

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TABLE 4
SELECTED AMT PREFERENCES AS PERCENTAGE OF TOTAL AMT PREFERENCES, PROJECTIONS FOR TAX YEARS 1997 AND 2007

AMT Preference	1997	2007
Personal exemptions	11.9%	40.9%
Standard deduction	1.2%	6.8%
State and local taxes	43.9%	38.6%
Medical deductions	0.4%	0.7%
Miscellaneous itemized deductions	16.0%	8.5%
Other preferences and adjustments	26.6%	4.5%

Source: Joint Committee on Taxation Individual Tax Model.

ten years, this situation will change. The standard deduction and personal exemption amounts are indexed for inflation, so for any given income level expressed in nominal dollars, the hypothetical family's regular income tax liability will be lower over time. Graphically, the indexation of the standard deduction and personal exemptions shifts the curves representing the regular income tax before and after credits down as we look at future years. Because the AMT exemption amount ($45,000 for a joint return) is not indexed for inflation and the standard deduction and personal exemptions are AMT preference items, the curve representing tentative AMT remains fixed.

Figure 7 shows what would happen to our hypothetical family in 2007 under present law. A family with AGI between $65,591 and $151,775 will have to reduce its dependent care credit because of the AMT. If its AGI is between $74,318 and $103,775, the family would lose the entire dependent care credit and would pay AMT taxes equal to the difference between the family's tentative AMT and its regular income tax before credits. For example, a taxpayer with the same family structure as our hypothetical family and AGI of $80,000 would have regular income tax liability before credits of $8,625.[21] Before consideration of the AMT, this taxpayer would be entitled to a dependent care credit of $960. However, this taxpayer's tentative AMT would be $9,100. Because his tentative AMT exceeds his regular income tax before credits, the taxpayer's entire dependent care credit would be disallowed and he would be required to pay a minimum tax of $475. In this example, the AMT has increased the taxpayer's tax liability by $1,435.

Our projections of the effect of the AMT on taxpayers claiming the standard deduction support the findings of our hypothetical example. In 1997, we project that approximately 0.4 percent of taxpayers with AGI between $75,000 and $100,000, who claim the standard deduction, will be affected by the AMT. By 2007, we project that this percentage will increase to 23.3 percent. The perception of the AMT as a tax on high-income individuals who make use of unusually high deductions will have to change in the future if there is no change in present law.

Distribution of the AMT

Table 5 presents the projected distribution of the AMT by AGI category for tax years 1997 and 2007. In 1997, 67 percent of taxpayers affected by the AMT had AGI greater than $100,000. These taxpayers will pay over 88 percent of the taxes collected by the AMT. By 2007, 57 percent of the taxpayers affected by the AMT will have AGI greater than $100,000.[22] The percentage of AMT returns with AGI over $200,000 will drop from 32 percent in 1997 to 17 percent by 2007. The share of AMT taxes from this AGI class will also decrease from 71 to 49 percent over the same period. Taxpayers with

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FIGURE 6. Tax Liability of Hypothetical Family, Tax Year 1997

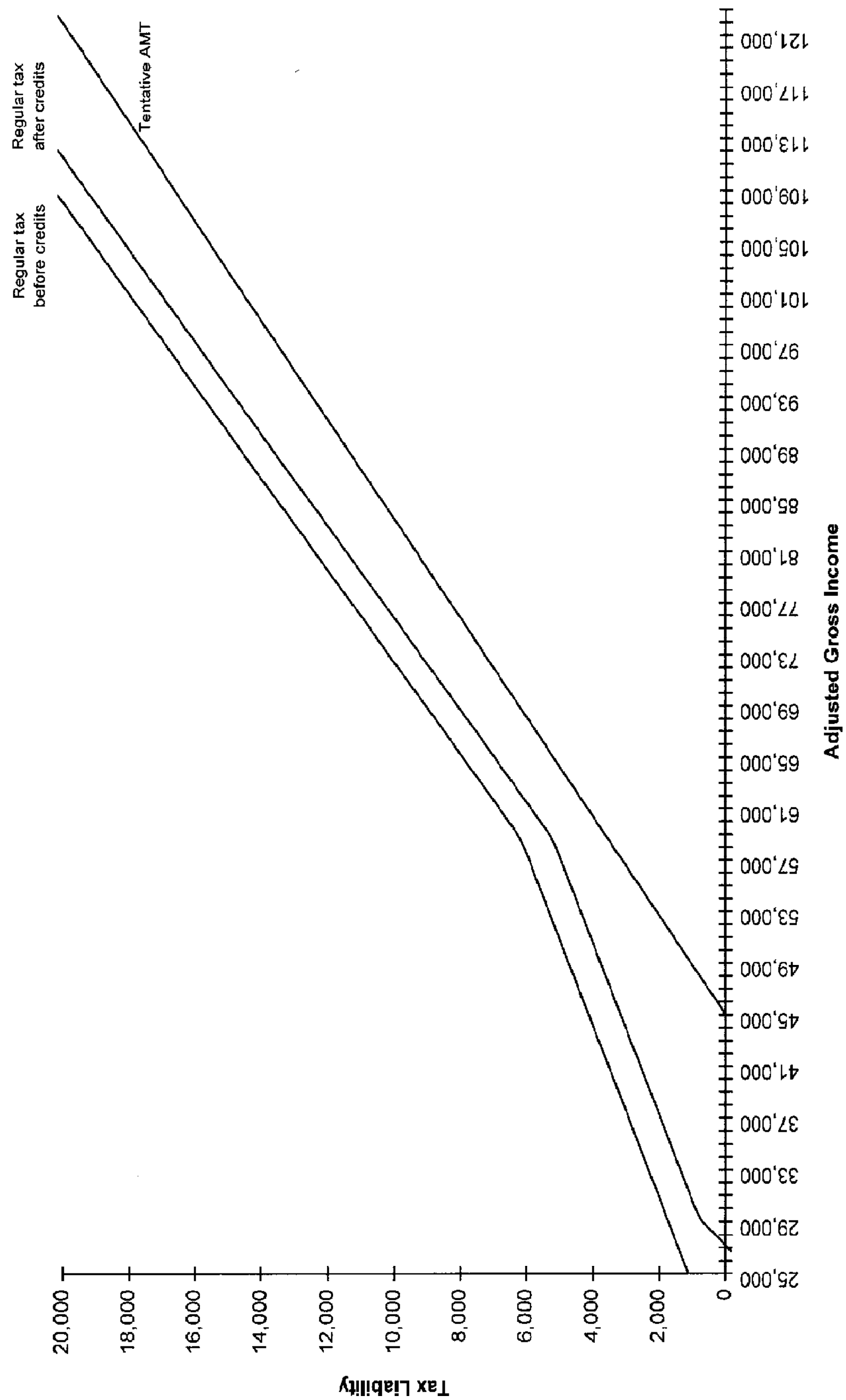

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FIGURE 7. Tax Liability of Hypothetical Family, Tax Year 2007

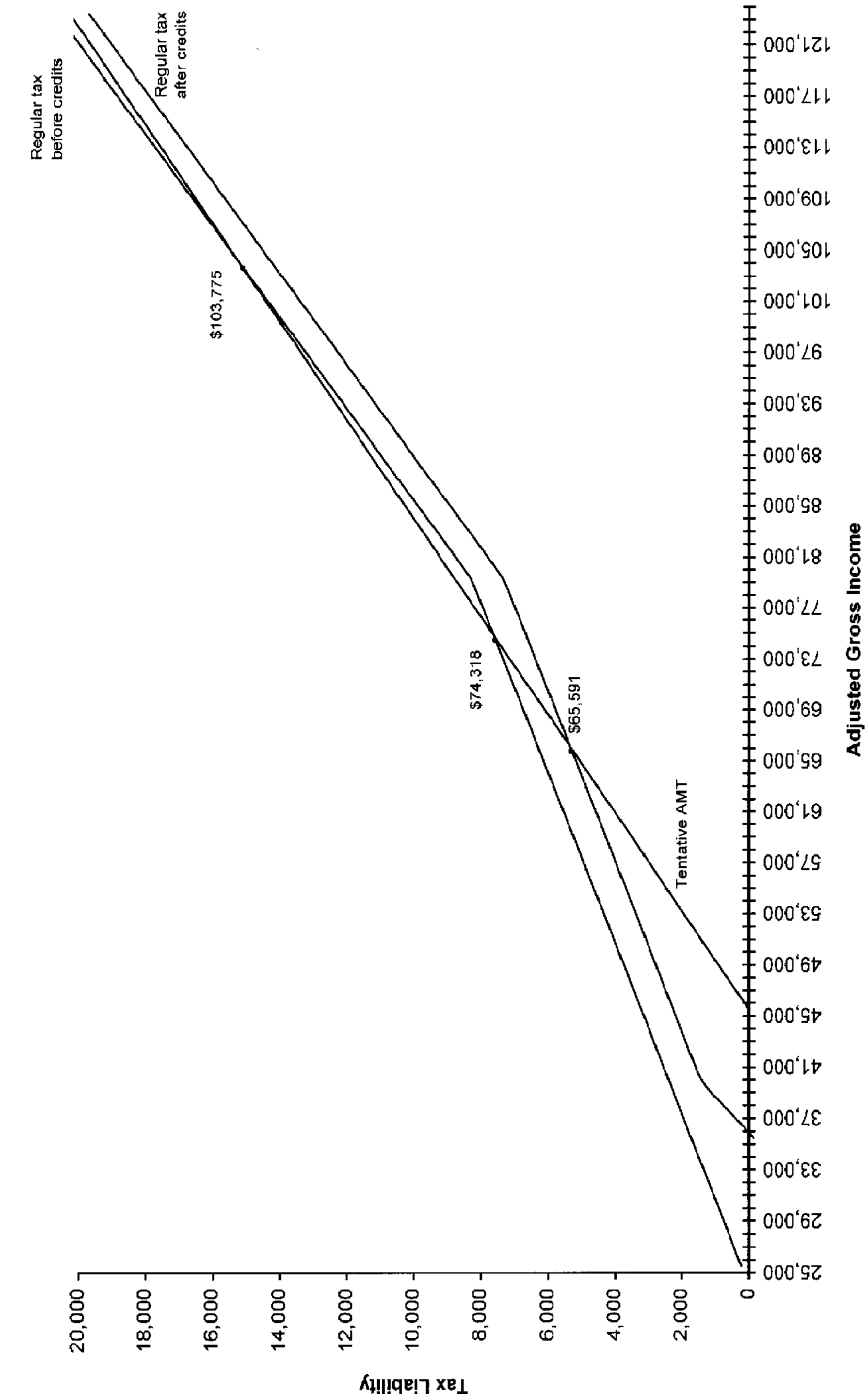

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TABLE 5
INCOME DISTRIBUTION OF AMT, PROJECTIONS FOR TAX YEARS 1997 AND 2007

Adjusted Gross Income (in Dollars)	1997 Percent of AMT Returns	1997 Percent of AMT Liability	2007 Percent of AMT Returns	2007 Percent of AMT Liability
< 50,000	7	4	3	2
50,000 – 100,000	26	7	40	17
100,000 – 200,000	35	17	40	31
200,000 – 500,000	26	33	16	34
> 500,000	6	38	1	16
Total, all returns	100	100*	100	100

Source: Joint Committee on Taxation Individual Tax Model.
*Sum does not equal 100 due to rounding error.

AGI between $50,000 and $100,000 will become an increasing percentage of taxpayers affected by the AMT. In 1997, 26 percent of AMT taxpayers had AGI between $50,000 and $100,000; by 2007, the percentage will increase to 40 percent. The share of AMT taxes will increase from 7 to 17 percent between 1997 and 2007 for taxpayers in this income class.

Indexation of the AMT

The sharp increase in the number of taxpayers affected by the AMT over the next ten years occurs because the main parameters of the regular income tax are indexed for inflation while the AMT parameters are not indexed. To demonstrate, we projected the number of taxpayers affected by the AMT and their AMT liability assuming that the main parameters of the AMT were indexed for inflation starting with tax year 1998. The three main parameters of the AMT that are indexed for this exercise are the AMT exemption, the income level at which the phaseout of the AMT exemption begins, and the income level at which the AMT marginal tax rate switches from 26 to 28 percent.

Figures 3 and 4 show the effect of indexing these parameters. With indexation, the number of taxpayers affected by the AMT increases from approximately 700,000 in tax year 1997 to just over 800,000 by tax year 2007. Therefore, approximately 8.2 million fewer taxpayers would be affected by the AMT if these AMT parameters were indexed for inflation beginning with tax year 1998.

With indexation of the AMT parameters, minimum tax receipts and lost credits would increase from $4.6 billion in 1997 to $7.2 billion by 2007, but as a percentage of total individual income tax revenues, revenues generated by the AMT would remain at 0.7 percent.

ENDNOTES

We are grateful to Jim Cilke, Jim Nunns, Mark Rider, and John Karl Scholz for their comments. We are especially grateful to Jim Cilke and Gordon Wilson for their superb computer assistance. The views expressed in this paper are those of the authors and do not necessarily reflect the views of the Joint Committee on Taxation or the U.S. Treasury Department.

1 The most recent detailed IRS data available on the AMT are for 1994.

2 In the four years in which the two minimum taxes overlapped, 1979–82, a taxpayer could have liability from both taxes.

3 The corporate minimum tax was also established in 1969.

4 The 1976 legislation also required the Treasury to publish annually the number of taxpayers with incomes greater than $200,000 who had no federal income tax liability.

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[5] Before 1987, a taxpayer's total AMT liability actually was the difference between his tentative AMT and his regular tax liability (before other taxes). The Tax Reform Act of 1986, however, changed the way AMT liability is currently reported. Under current law, tax credits lost by a taxpayer because of the AMT are reflected in the credit forms themselves rather than on the AMT form. Thus, AMT liability currently is the difference between tentative AMT and regular tax liability (before other taxes) plus lost credits. An example should clarify. Assume a taxpayer has regular tax liability of $10,000 (before credits and other taxes), $500 in tax credits (all lost because of the AMT) and tentative AMT of $11,000. Under pre-1987 law, the taxpayer would report regular tax liability of $9,500 and tentative AMT of $11,000; the taxpayer's AMT liability was reported as $1,500. Under current law, the taxpayer would report regular tax liability of $10,000 (lost credits are reflected on the credit forms) and tentative AMT of $11,000; the taxpayer's AMT liability is reported as $1,000 (as calculated on the AMT form). But the actual effect of the AMT under current law is still $1,500 ($500 in lost credits and $1,000 in liability off the AMT form).

[6] Personal exemptions are not explicitly included as an AMT preference item on the AMT form. Because the AMT form starts with line 35 of Form 1040, the fact that personal exemptions are effectively an AMT preference is obscured. Personal exemptions, however, should be considered as a preference item because the AMT does not allow deductions for personal exemptions.

[7] Taxpayers can prevent certain preferences from being treated as AMT preferences if they use the AMT treatment of these items when figuring their regular tax. The preferences for which the optional write-off can be used are (1) research and experimental expenses, (2) circulation expenses, (3) intangible drilling costs, and (4) mining exploration and development costs.

[8] The empowerment zone employment credit, which was established in 1993, can offset up to 25 percent of a taxpayer's AMT liability.

[9] The amount of lost credits, however, does not necessarily represent additional revenue to the government from the AMT. Lost GBCs can be carried back three years to offset prior year regular tax liability. Lost credits that are carried back represent no additional revenue for the government from the AMT. Lost GBCs that cannot be carried back can be carried forward 15 years; lost AMT credits can be carried forward indefinitely. As a result of these carryforwards, some of the tax credits used to reduce regular tax liability for non-AMT taxpayers in 1994 may represent lost credits from previous years, and some of the credits lost in 1994 may be used to reduce regular tax liability in future years. Some of 1994's lost credits might actually have been lost credits from 1993 that were carried forward to 1994.

[10] The general business credits affected by the AMT are as follows: (1) investment, (2) targeted jobs, (3) alcohol fuels, (4) research and experimental, (5) low-income housing, (6) enhanced oil recovery, (7) disabled access, (8) renewable electricity production, (9) Indian employment, and (10) employment social security. In addition, at least 75 percent of the empowerment zone employment credit is lost because of the AMT.

[11] The other credits that can be lost because of the AMT are as follows: (1) child and dependent care, (2) elderly or disabled, (3) nonconventional fuels, (4) electric vehicles, (5) orphan drug, (6) investment, (7) targeted jobs, (8) alcohol fuels, (9) research expenditures, (10) low-income housing, and (11) enhanced oil recovery, (12) disabled access, (13) renewable electricity production, (14) mortgage interest, and (15) earned income tax.

[12] The corporate AMT, unlike the individual AMT, allows all AMT liability to offset future corporate regular tax liability in excess of tentative AMT.

[13] Lost credits for nonconventional fuels and orphan drugs are treated exactly the same as AMT credits generated from deferral preferences and can be carried forward indefinitely.

[14] Capital gains realizations increased from $132 billion in 1985 to $343 billion in 1986.

[15] The panel consists of a weighted sample of taxpayers who filed a tax return in 1985 and in each year of the 1991–4 period. The panel accounts for 68 million taxpayers, about 60 percent of the total number of taxpayers in 1994.

[16] The source of all projections of individual income tax liabilities presented in this section is the Joint Committee on Taxation individual income tax model.

[17] The income categories are reported in nominal dollars.

[18] Likewise, there would be a large increase in the percentage of taxpayers who itemize their deductions and pay the AMT. In 1997, 1.9 percent of taxpayers with positive tax liability who itemize will pay the AMT. By 2007, this percentage will increase to 17.6 percent.

[19] In 1997, the standard deduction for joint filers is $6,900 and the personal exemption is $2,650.

[20] The dependent care credit applies to employment-related expenses up to $4,800 for two or more qualifying dependents. The credit rate is 30 percent for taxpayers with AGI less than $10,000 phasing down to 20 percent for taxpayers with AGI over $28,000. The dependent care credit is included in this example to show how the AMT affects individual income tax credits.

[21] It is projected that the standard deduction for taxpayers filing a joint return will increase to $9,300 for tax year 2007, and the personal

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exemption amount for that year is projected to be $3,550.

22 These income categories are not adjusted for inflation. Hence, while the percentage of AMT taxpayers with income above $100,000 decreases between 1997 and 2007, the percentage of all taxable returns reporting AGI greater than $100,000 is projected to increase from 7 percent of taxable returns to 15 percent during this same ten-year period.

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