

# **CBO TESTIMONY**

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**Statement of  
Douglas Holtz-Eakin  
Director**

## **The Individual Alternative Minimum Tax**

**before the  
Subcommittee on Taxation and IRS Oversight  
Committee on Finance  
United States Senate**

**May 23, 2005**

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WASHINGTON, D.C. 20515**



Mr. Chairman and Members of the Subcommittee, thank you for inviting the Congressional Budget Office (CBO) to testify about the individual alternative minimum tax (AMT). The AMT was originally designed to limit the use of tax preferences (exclusions or deductions from a comprehensive measure of income) by high-income taxpayers to ensure that they paid at least some income tax. Under the AMT, a parallel tax system was established with a more limited set of tax preferences than those that apply under the regular income tax and with its own set of exemptions and tax-rate schedule. Taxpayers are required to pay whichever is greater—the tax they owe under the AMT or the tax they owe under the regular income tax.

## **The Growing Significance of the AMT**

The number of taxpayers who are affected by the AMT and the revenues that are collected as a result of it have been growing over time. Thus far, the share of tax filers who are subject to the AMT has been small, reaching 1 percent of filers for the first time in tax year 2000. Under current law, however, the AMT is expected to extend its reach (see Figure 1). In 2002, about 2 million taxpayers paid additional taxes as a result of the AMT; in 2010, roughly 30 million taxpayers are expected to owe more because of it. And those figures do not include the even greater number of filers who are required to calculate their taxes under both the AMT and the regular tax to determine whether they owe more under the alternative tax.

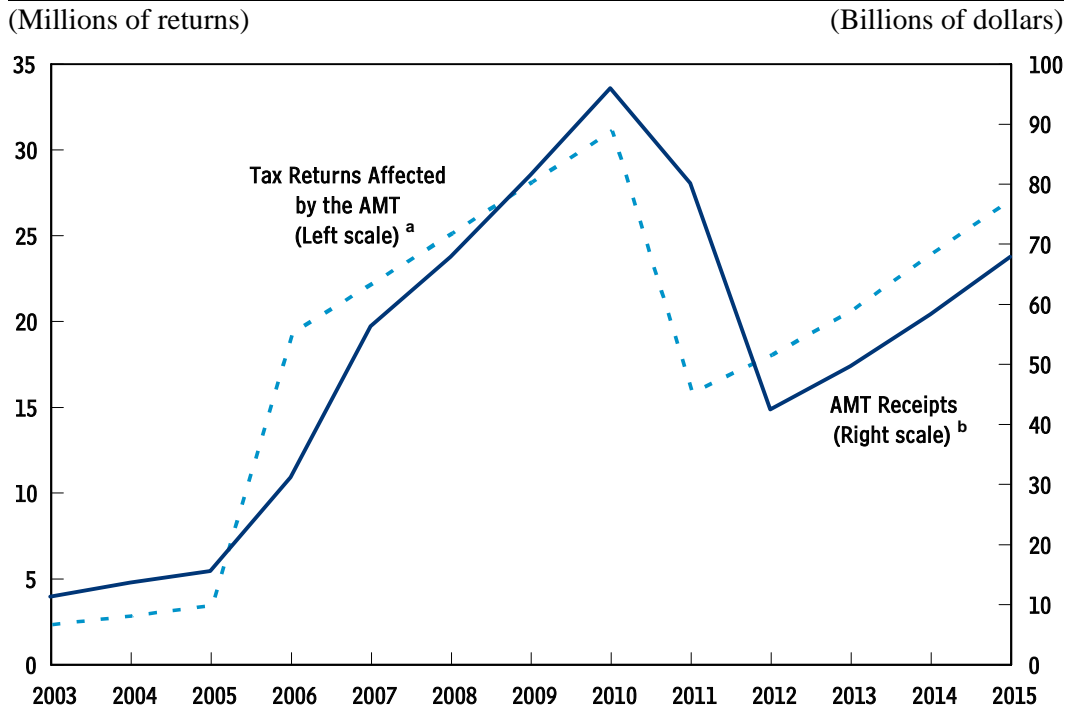
Revenues from the AMT will make up a growing share of individual income tax receipts over the next 10 years. In CBO's estimation, the federal government received an additional \$14 billion in fiscal year 2004 from the AMT, and those added revenues are expected to grow to about \$95 billion in fiscal year 2010. Over the 2005-2015 period, CBO's baseline includes about \$645 billion in revenues from the AMT, or roughly 4 percent of personal income tax receipts.

## **Why Is the Impact of the AMT Increasing Over Time?**

Two factors are spurring the growth that is occurring in the number of taxpayers affected by the AMT. First, unlike the parameters of the regular tax, the parameters of the AMT are not indexed for inflation. Under the regular tax, the personal exemption, standard deduction, and rate brackets are all indexed, which prevents tax rates from rising when incomes just keep pace with inflation. By contrast, the parameters of the AMT—the exemption and rate brackets—are not indexed. Over time, taxpayers face higher tax rates under the AMT, even if their incomes grow only at the pace of overall price rises. Because inflation boosts tax rates under the AMT but does not raise rates under the regular income tax, as prices rise, a greater number of taxpayers will owe more under the AMT than under the regular tax. In addition, the effects of inflation on the AMT accumulate over time. CBO estimates that if current law remained in effect, 70 percent of taxpayers in 2050 would be affected by the AMT, and the additional revenues

**Figure 1.**

## **Projected Effects of the Individual Alternative Minimum Tax**



Source: Congressional Budget Office.

a. Calendar year basis.

b. Fiscal year basis.

from it would account for 20 percent of the personal income taxes collected by the government (see Figure 2).<sup>1</sup>

The second factor that may cause more taxpayers to be affected by the AMT in the next few years is reductions in regular income taxes. The tax cuts enacted in 2001, 2003, and 2004 resulted in more taxpayers becoming subject to the alternative tax, although that effect was mitigated somewhat by a temporary increase in the AMT exemption that is scheduled to expire after 2005.<sup>2</sup> The interaction of the AMT and

1. See Congressional Budget Office, *The Long-Term Budget Outlook* (December 2003). In its calculations, CBO assumed that inflation would be 2.5 percent through 2050.

2. The recent laws that reduced regular income taxes are the Economic Growth and Tax Relief Reconciliation Act of 2001, the Jobs and Growth Tax Relief Reconciliation Act of 2003, and the Working Families Tax Relief Act of 2004.

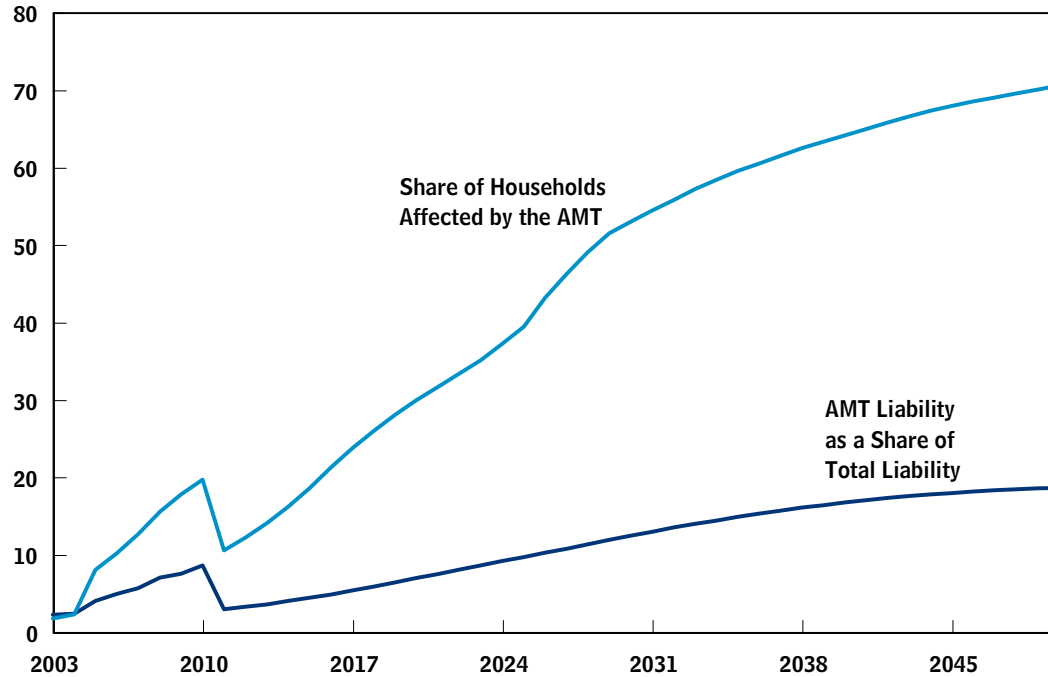
**Figure 2.**

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## **The AMT's Impact on Individual Income Tax Liabilities Under Current Law, 2003 to 2050**

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(Percent)



Source: Congressional Budget Office.

Note: AMT = alternative minimum tax.

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those tax law changes is illustrated by the expected drop after 2010 in the number of taxpayers that the AMT affects (see Figure 1). That number falls from about 30 million to 16 million between 2010 and 2011, when the 2001 changes are scheduled to expire, and then begins to increase again after 2011 as a result of inflation.

### **Who Is Affected by the AMT?**

The types of taxpayers who are affected by the AMT are changing over time. Historically, many of those subject to it were the relatively small number of filers who used a narrow set of tax preferences that were not allowed under the alternative tax. (For example, relatively few taxpayers are eligible for incentive stock options, which receive less favorable treatment under the AMT than under the regular income tax.) In the years to come, however, the preferences that are not allowed under the AMT and that will move taxpayers within its sphere are some of the more widely used features of the regular tax, such as the personal exemption (which is used by all taxpayers) and the standard deduction (which is

used by roughly two-thirds of filers). The AMT potentially affects almost all filers who itemize because they generally claim a deduction for state and local taxes, which is not allowed under the AMT. That broad reach of the tax suggests that taxpayers in larger families (who have a greater number of personal exemptions) and taxpayers with larger deductions for state and local taxes will tend to be more affected by the AMT than will other taxpayers.

Also likely to experience more of an effect will be married couples—relative to unmarried taxpayers with similar incomes. Married couples are treated more generously under the regular tax than under the AMT. In 2005, for example, the standard deduction for married couples under the regular tax is twice that for single filers, whereas the exemption amount for married couples under the AMT is only 37 percent larger. That relatively favorable treatment of married filers under the regular income tax means that they are more likely to become subject to the AMT. Married couples also tend to have larger families and are therefore more affected by the elimination of personal exemptions under the alternative tax. In 2010, only 5 percent of unmarried taxpayers will be subject to the AMT, CBO estimates, whereas the number of married taxpayers affected will be almost 40 percent. Among married taxpayers, about 30 percent of those without children are expected to be within the AMT's reach, and over half of those with at least two children will owe more as a result of the alternative tax (see Figure 3).

The impact of the AMT varies among taxpayers with different incomes (see Figure 4). The share of taxpayers affected by it is projected to grow through 2010 for all income groups, although the share is expected to expand the most for taxpayers with incomes between \$50,000 and \$500,000.<sup>3</sup> Under current law, in 2010 (the year of the AMT's peak effect during CBO's current baseline projection period), two-thirds of the 26 million taxpayers with adjusted gross income (AGI) between \$50,000 and \$100,000 will owe more tax as a result of the AMT. Among the 9 million taxpayers with AGI between \$100,000 and \$500,000, more than 85 percent will owe more tax.

A smaller portion of the highest-income taxpayers—less than one-third—will be affected by the AMT in 2010, and relatively few taxpayers with incomes of less than \$50,000 will feel an impact. The highest-income taxpayers are less affected by the AMT because the top rate under the regular tax (35 percent) is higher than the top rate under the AMT (28 percent). Therefore, most of the highest-income taxpayers will owe more under the regular tax than under the AMT. The lowest-income taxpayers (those whose incomes are less than \$50,000) remain largely

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3. Income figures are in 2005 dollars.

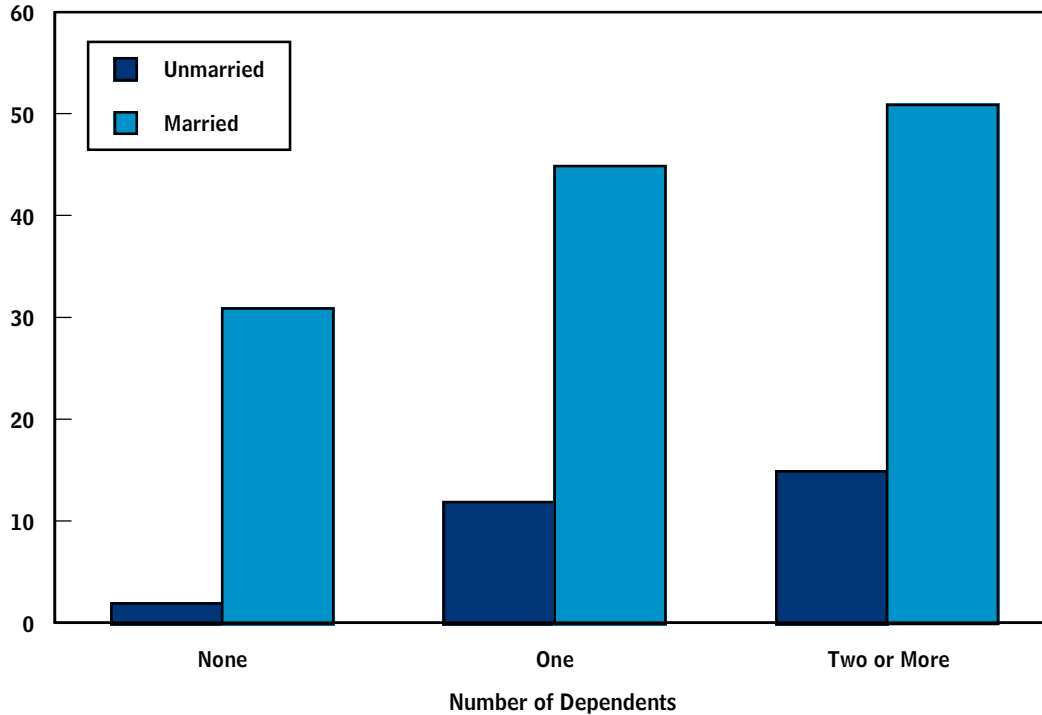
**Figure 3.**

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**Percentage of Taxpayers Projected to Pay the AMT in 2010, by Marital Status and Number of Dependents**

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(Percent)



Source: Congressional Budget Office.

Notes: CBO projects that in 2010, there will be 100 million unmarried and 60 million married taxpayers.

AMT = alternative minimum tax.

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unaffected by the tax in 2010 because the AMT's exemption prevents much of their income from becoming subject to the AMT.

### **Is the Growing Reach of the AMT a Problem?**

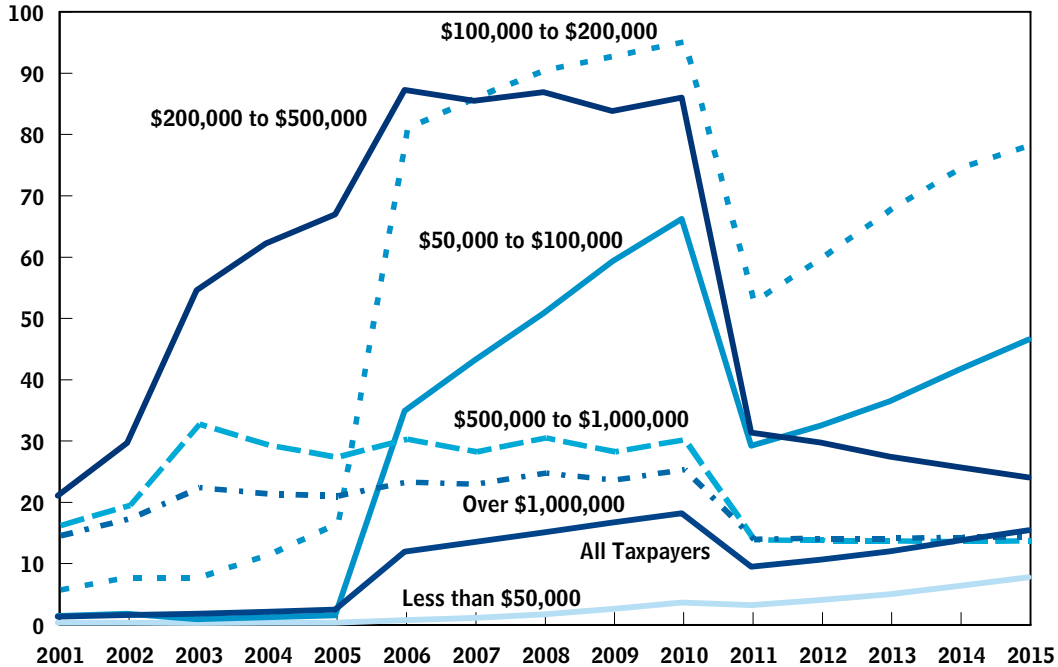
The AMT imposes multiple costs on taxpayers and the economy. Most directly, it increases individual tax liabilities and adds complexity to the calculation of taxes. But it may also impose indirect costs—for example, by affecting people's behavior in ways that can have an adverse economic impact. Both kinds of costs must be taken into account in evaluating the alternative minimum tax.

Although the basic calculation for the AMT appears simple, it is actually complex in a variety of ways. For example, it complicates one of the most basic of tax-filing questions: whether to itemize deductions. Under the regular income tax, the decisionmaking process is relatively easy: sum up all deductions that may be

**Figure 4.**

## **Taxpayers with AMT Liability, by Adjusted Gross Income in 2005 Dollars, Calendar Years 2001 to 2014**

(Percentage of taxpayers)



Source: Congressional Budget Office.  
Note: AMT = alternative minimum tax.

itemized; adjust for the phaseout, if it is applicable; compare the result with the appropriate standard deduction; and claim the larger of the two amounts. In calculating their tax liability under the AMT, taxpayers must make the same decision about deductions that they would make for the regular tax: whether to either itemize or claim the standard deduction. Taxpayers who claim the standard deduction under the regular tax cannot itemize their deductions under the AMT. However, because some itemized deductions may be claimed under the alternative tax, some taxpayers who are subject to it will have a smaller total tax liability if they claim itemized deductions that total less than their standard deduction. That factor increases to four the number of potential liabilities that a taxpayer must calculate to determine first, whether he or she is liable for the AMT, and second, how to pay the smallest amount of tax.

Much of the complexity created by the AMT can be lessened by using computer software to prepare tax-filing forms. Programs available on the Internet or for installation on individual computers automatically determine whether taxpayers have AMT liability and create the required paperwork. But not all taxpayers have



access to computers; furthermore, use of the software can raise the costs of tax preparation for many people. In addition, some taxpayers move on and off the AMT over time. As a result, they are subject to a set of continually changing tax rules and rates.

The alternative tax may cause taxpayers to change their behavior—at least to the extent that they know that the AMT may affect them—which could reduce economic efficiency. Under the AMT, taxpayers may be subject to higher marginal tax rates (the tax on an additional dollar of income), which in turn may influence their decisions about how much to work and save. Many taxpayers face higher marginal rates under the AMT than they would under the regular tax. Changes in the structure of the alternative tax could help lower those rates, but how those changes affected the economy would depend on whether other tax rates were raised to make up for the lost revenues.

## **Options for Changing the AMT**

The increasing impact of the AMT has generated interest in changing or repealing it. The most straightforward approach to curtailing the growth of the AMT would be to eliminate the tax entirely, which would reduce revenues by roughly \$600 billion over the next decade (see Table 1). Eliminating the AMT would free many taxpayers from having to make a second set of tax calculations and would lower taxes for nearly everyone who is now subject to the AMT. The repeal approach, however, might raise concerns that some high-income individuals would pay little or no tax through the use of various tax preferences and so undermine the original purpose of the alternative levy.

Short of repeal, there are several options that could limit the AMT's expected growth. Over the longer run, the reach of the tax will expand primarily because in nominal terms, its parameters are fixed, whereas the parameters of the regular income tax are adjusted annually to take account of inflation. The current AMT exemption is \$58,000 for married couples filing jointly and \$40,250 for unmarried filers. After 2005, however, those amounts are scheduled to revert to their pre-2001 levels of \$45,000 and \$33,750, respectively. Extending the current exemption levels just for 2006 would keep about 14 million taxpayers from incurring AMT liability for that year and reduce the tax burden of others—at a cost of about \$30 billion in forgone revenues. If the 2005 exemptions were made permanent and, along with other AMT parameters, indexed for inflation after 2006, most of the increase over the coming decade in the number of taxpayers with AMT liability would disappear. Under that option, about 7 million taxpayers would incur such a liability in 2010, a reduction of more than 75 percent from the estimated 29 million taxpayers who would otherwise owe the alternative tax in that year. The option would reduce federal revenues by about \$385 billion over the 2006-2015 period.

**Table 1.****How the AMT Options Affect Revenues and Taxpayers**

	<b>Reduced Receipts, Fiscal Years 2006 to 2015<sup>a</sup> (Billions of dollars)</b>	<b>Number of Taxpayers Subject to the AMT in 2010<sup>b</sup> (Millions)</b>
Repeal the AMT	611	0
Extend the 2005 Exemption to 2006 and Index All Parameters Thereafter	385	7
Allow Personal Exemptions Under the AMT	343	11
Allow State and Local Tax Deductions Under the AMT	423	17
Allow the Standard Deduction Under the AMT	64	23

Sources: Congressional Budget Office; Joint Committee on Taxation.

a. The effective date for the options is assumed to be January 2006.

b. The number of taxpayers subject to the AMT in 2010 under current law is 29 million.

Another alternative for mitigating the impact of the AMT would be to allow certain preferences under it that are expected to affect a growing number of taxpayers. Permitting the same personal and dependent exemptions under the AMT as under the regular income tax would remove about 18 million tax units from the AMT's reach in 2010, or more than 60 percent of all taxpayers who would owe the alternative tax under current law in that year. The option would reduce federal revenues by about \$343 billion between 2006 and 2015.

Alternatively, allowing taxpayers to deduct state and local taxes for the purposes of the AMT would eliminate its impact for about 12 million taxpayers in 2010 (roughly 40 percent of those who would pay the tax in that year under current law) and reduce federal revenues by about \$423 billion during the 2006-2015 period.

Allowing the standard deduction under the AMT would have the smallest effect on revenues of any option discussed here other than the one-year extension of the higher exemption amount. If the standard deduction was allowed, revenues would be reduced by about \$64 billion between 2006 and 2015, and the AMT's effect would be eliminated for 6 million taxpayers in 2010.

## **Is the AMT a Good Alternative to the Regular Tax?**

Some commentators have suggested that instead of repealing the AMT, it would be preferable to repeal the regular tax and rely on the AMT's broader base and lower rates. That option, according to its proponents, would have several advantages. The AMT is nearly a flat-rate tax. It eliminates a variety of special tax breaks in the regular tax system—that is, it applies to a broader base of income and over the long run generates more revenue than the regular income tax.

However, in practice, the AMT is less “flat” than it might appear. First, in addition to the tax's statutory rates of 26 percent and 28 percent, the AMT has additional effective marginal rates equal to 32.5 percent and 35 percent—which are caused by the phasing out of the tax's exempt amount (for 2005, \$58,000 for married taxpayers and \$40,250 for unmarried taxpayers). Thus, the AMT's effective rate structure is 26 percent, 32.5 percent, 35 percent, and 28 percent, the last being the rate that applies to the highest incomes.

Second, the tax base of the AMT was designed as a companion to that of the regular income tax. Consequently, the AMT's base might not make as much sense if the tax were recast as a stand-alone levy. For example, under the regular income tax, as a family's size increases, personal exemptions reduce its taxes, but as more and more families were affected by the AMT, that adjustment for family size would disappear. Moreover, although the elimination of some preferences under the AMT would simplify the tax system, for most taxpayers the main difference between the AMT and the regular income tax is in the rate schedule and not in the definition of income and deductions. Put differently, the AMT's tax base is not as broad as that of a truly comprehensive tax; at the same time, it is broader than the base of the regular tax in ways that may not be desirable for the tax system as a whole.

Third, revenues would grow more quickly under the AMT than under the regular tax, but much of that extra growth would stem from the fact that the AMT is not indexed for inflation. As a result, for the same level of real (inflation-adjusted) income, tax rates would rise over time.







## **Related CBO Publications**

*The Budget and Economic Outlook: Fiscal Years 2006 to 2015* (January 2005).

*The Alternative Minimum Tax, Revenue and Tax Policy Brief No. 4* (April 15, 2004).

*The Long-Term Budget Outlook* (December 2003).