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The Alternative Minimum Tax (AMT): Income Entry Points and "Take Back" Effects

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Summary

The alternative minimum tax for individuals (AMT) was originally enacted to ensure that high-income taxpayers paid a fair share of the federal income tax. However, the lack of indexation of the AMT coupled with the recent reductions in regular income taxes has greatly expanded the potential impact of this tax.

Temporary increases in the AMT exemption amounts are scheduled to expire at the end of 2004. If this occurs, then the number of taxpayers subject to the AMT will jump from 3 million in 2004 to over 16 million in 2005. Families with large numbers of children will be especially hard hit. For example, if the temporary increase in the AMT exemption expires, then in 2005, married couples with four children will be subject to the AMT when their incomes exceed approximately $58,500. In addition, if left unchanged, the AMT will "take back" much of the recently enacted reductions in the regular income tax. For instance, in 2008, a family of four with $80,000 of income will see $1,585 of regular income tax reductions taken back by the AMT.

Fixing the AMT will be expensive. Assuming the recent reductions in the regular individual income are extended past 2010, repeal of the AMT would reduce federal tax revenues by over $1 trillion between 2005 and 2014. Projections indicate that by 2013 it would be less expensive to repeal the regular income tax than to repeal the AMT.

Congress is considering going to conference on a child tax credit refundability bill (H.R. 1308) that was passed last year, and using the conference agreement as a vehicle for extending several expiring tax reductions. A temporary extension of the AMT exemption increase is likely to be included in this legislation.

This report will be updated as legislative action warrants.

The alternative minimum tax for individuals (AMT) was originally designed to prevent a small number of high-income taxpayers from escaping their "fair" share of income taxes through the use of special preferences under the regular income tax.[1] In the absence of legislative action, however, the number of taxpayers falling under the AMT is going to increase dramatically over the next few years.

There are two main reasons for the increase in the number of taxpayers affected by the AMT. First, the regular income tax is indexed for inflation but the AMT is not. Over time this has produced a reduction in the differences between regular income tax liabilities and AMT liabilities at any given nominal income level, differences that will continue to shrink in the absence of AMT indexation.

Second, recent tax reductions under the regular income tax have further narrowed the differences between regular and AMT tax liabilities. These tax reductions in the regular income tax occurred in the Economic Growth and Tax Relief Reconciliation Act of 2001 (P.L. 107-16; EGTRRA) and the Jobs and Growth Tax Relief Reconciliation Act of 2003 (P.L. 108-27; JGTRRA). In addition to reducing taxes under the regular income tax, both of these measures also contained temporary increases in the AMT exemption designed to mitigate the interaction between the reductions in the regular income tax and the AMT. The temporary increases in the AMT exemptions, however, expire at the end of 2004.

The combination of these two factors — the lack of AMT indexation and reductions in the regular income tax — means that, absent legislative changes, there will be a significant growth in the number of taxpayers affected by the AMT.[2] It is estimated that in 2004, about 3 million taxpayers will pay the AMT. If the temporary AMT exemption increase is not extended beyond 2004, then about 16 million taxpayers will pay the AMT in 2005. By 2014, if the EGTRRA/JGTRRA tax cuts are extended, then the number of taxpayers paying the AMT will increase to over 46 million.[3]

Calculating AMT Liabilities

Under current law, to calculate AMT tax liability an individual first adds back various tax items (called adjustments and preferences) to his regular taxable income. The three major preference items added back to the AMT tax base are personal exemptions, state and local tax deductions, and miscellaneous itemized deductions. These three items account for over 90% of the total AMT preference items and adjustments that are added back to regular taxable income for AMT purposes. Other items subject to tax under the AMT include net operating losses, passive activity losses, incentive stock options, and private activity bond interest.

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[1] For a detailed history and explanation of the AMT see CRS Report RL30149, *The Alternative Minimum Tax for Individuals,* by Gregg Esenwein.

[2] In addition, even though a taxpayer may not actually pay the AMT, it can still affect his tax liability because certain non-refundable tax credits under the regular income tax are limited to the excess of regular income tax liability over AMT liability. Temporary provisions which had allowed taxpayers to use personal tax credits against both their regular and AMT liabilities expired at the end of 2003. The child tax credit, the adoption tax credit, and the IRA contribution credit, however, can all be applied against both the regular income tax and the AMT.

[3] U.S. Department of the Treasury. *Fact Sheet: The Toll of Two Taxes: The Regular Individual Income Tax and the AMT.* JS-1293, Apr. 2, 2004.

This grossed up income becomes the tax base for the AMT. An exemption of $58,000 for joint returns and $40,250 for single and head of household returns is subtracted to obtain AMT taxable income. (These exemption levels are temporary and are scheduled to revert, in 2005, to their prior law levels of $45,000 for joint returns and $35,750 for unmarried taxpayers.) The basic AMT exemption is phased out for taxpayers with high levels of AMT income. A two-tiered rate structure of 26% and 28% is assessed against AMT taxable income. The tax is 26% of AMT taxable income up to $175,000 and 28% of AMT taxable income in excess of $175,000. The taxpayer compares his AMT tax liability to his regular tax liability and pays the greater of the two.

Income Entry Points for the AMT

Table 1 below shows the 2004 income levels at which joint returns with up to six children would be subject to the AMT in 2004, 2005, and 2008. That is, it shows the income levels at which the AMT for these returns would be higher than their regular income taxes and, and as a result, they would pay the AMT. The table assumes that families use the standard deduction under the regular income tax and have no AMT preferences or adjustments other than their personal exemptions.[4]

In 2004, families with five or more children and incomes in excess of approximately $83,000 will be subject to the AMT. This small overlap between the regular income tax and the AMT is the result of the temporary increase, from $45,000 to $58,000, in the AMT exemption.

In 2005, when the AMT exemption returns to $45,000 for joint returns, the overlap between the regular income tax and the AMT increases dramatically. In 2005, families with six or more children will be subject to the AMT at income levels exceeding approximately $50,000. The table also shows that even smaller families and childless married couples with relatively modest incomes will be subject to the AMT in 2005. This trend continues in 2008 with the income entry point for the AMT falling to only $66,636 for married couples with no children. In 2008, families with four children will fall under the AMT at income levels exceeding approximately $50,000.

[4] Families with large amounts of AMT preference items in addition to their personal exemptions might face income entry points for the AMT that are lower than those shown in Table 1.

Table 1. Joint Return Income Entry Points for the AMT
(Income Amounts Expressed in Constant 2004 Dollars)

Year	Number of Children						
	None	1	2	3	4	5	6
2004	—— —	—— —	—— —	—— —	—— —	$87,773	$83,546
2005	$89,563	$71,095	$66,923	$62,753	$58,583	$54,413	$50,243
2008	$66,636	$62,456	$58,277	$54,092	$49,917	$45,736	—— —

Note: Calculated by CRS. Assumes use of the standard deduction and that the families have no AMT preference items other than their personal exemptions. Also assumes 3% inflation per annum. Blank cells indicate no overlap between the regular income tax and the AMT under these assumptions.

"Take Back" Effect of the AMT

Table 2 shows the "take back" effect of the AMT in 2008. That is, the table shows how much of the EGTRRA/JGTRRA tax cuts will be lost if the AMT exemption amount reverts back to $45,000 and remains unindexed. For example, consider the case of a joint return with two children and an income of $70,000. If the tax cuts had not been enacted then their regular income tax liability in 2008 would have been $5,958. Their AMT tax liability would have been $4,500. Since their AMT would have been less than their regular income tax liability, they would have paid their regular income tax of $5,958.

However, under current law (which includes the effects of the tax cuts) this family's regular income tax liability in 2008 will be $4,015. Their AMT liability will still be $4,500. Since their AMT liability is higher than their regular income tax, they would pay the AMT of $4,500. In essence, the AMT takes back $485 of the EGTRRA/JGTRAA tax reductions (the difference between the family's regular income tax liability, $4,015 and their $4,500 AMT liability).

Table 2. "Take Back" Effect of AMT in 2008 on Recent Tax Cuts Married Couples with Two Children Under 17 Years Old

2008 Income Levels	Income Taxes Assuming Pre-2001 Tax Law (Pre-tax Cut)	Income Taxes Assuming Current Law	AMT under Current Law	AMT Take Back of Enacted Tax Cuts	Percentage of Tax Cut Lost to AMT
$70,000	$5,958	$4,015	$4,500	$485	25%
$75,000	$6,800	$4,765	$5,800	$1,035	51%
$80,000	$8,100	$5,515	$7,100	$1,585	61%
$90,000	$10,700	$7,015	$9,700	$2,685	73%
$100,000	$13,300	$9,511	$12,300	$2,789	74%
$120,000	$18,762	$14,511	$17,500	$2,989	70%

Note: Calculated by CRS. Assumes earned income, use of standard deduction, and that the only personal tax credits claimed are the child tax credit.

As can be seen in the table, higher income families see a larger dollar take back than do lower income families. In percentage terms, the take back increases as income increases through $100,000 and then starts to decrease at higher levels of income. In these examples the hardest hit family has a $100,000 income. Under pre-tax-cut law, their income tax in 2008 would have been $13,300. With the tax cuts, their regular income tax will fall to $9,511, a reduction of $3,789. However, the AMT effectively takes back $2,789 of the cut in their regular income taxes, a 74% reduction.

Revenue Costs of Fixing the AMT

The revenue costs of fixing the AMT are substantial. The Treasury Department estimates that the AMT will raise $28 billion of additional revenue in 2005. By 2014, it will bring in $177 billion in revenue. The Treasury projects that by 2013, it would be less expensive to repeal the regular income tax than it would be to repeal the AMT. Other analysts predict that the crossover point will come much sooner.[5]

Outright repeal of the AMT would be expensive. The Tax Policy Center of the Urban Institute estimates that outright repeal of the AMT would reduce federal tax revenues by $660 billion between 2005 and 2014 assuming the EGTRRA/JGTRRA tax cuts expire as scheduled in 2010. If these tax cuts are extended, then the cost of AMT repeal would rise to over $1 trillion.

Other less costly options include allowing the use of personal tax credits against the AMT, extending the increase in the AMT exemption, and indexing the AMT. As shown in Table 3, however, even these options are relatively expensive. For instance, allowing

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[5] See, for example, Urban Brookings Tax Policy Center. *Key Points on the Alternative Minimum Tax*, Jan. 21, 2004.

personal tax credits against the AMT and extending the increase in the AMT exemption would cost $204 billion between 2004 and 2010. Adding AMT indexation would increase the cost to $231 billion.

Table 3. Costs of AMT Modifications
(Billions of Dollars)

	2004	2005	2006	2007	2008	2009	2010	Total
Allow Personal Credits Against AMT	-0.1	-0.6	-2	-4	-4	-5	-6	-22
Extend Increased AMT Exemption	——	-7	-20	-27	-34	-43	-51	-182
Extend Increased AMT Exemption and Indexation	——	-7	-21	-29	-39	-51	-62	-209

Source: Congressional Budget Office. *The Budget and Economic Outlook: Fiscal Years 2005 to 2014*.

If the recent reductions in the regular income tax are extended beyond their scheduled sunset date of 2010, the costs of each of the preceding AMT modifications would grow considerably.