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State and Local Taxes and the Federal Alternative Minimum Tax

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State and Local Taxes and the Federal Alternative Minimum Tax

Summary

The alternative minimum tax (AMT) is a parallel tax to the regular individual income tax and is intended to help ensure that high-income individuals bear at least some tax liability. The recent major tax cuts, however, lowered the average tax liability under the regular income tax such that many taxpayers could have been captured by the AMT, which is not indexed for inflation. The AMT for individuals will capture significantly more taxpayers beginning in 2006 if Congress does not act to modify or repeal the tax. This report describes the potential impact on taxpayers and state and local governments if the AMT reverts to pre-2001 rules or is repealed. Both taxpayers and state and local governments are potentially affected because state and local taxes are deducted for purposes of the regular income tax, but are not deducted when calculating AMT liability.

The impact on state and local governments arises because the tax price of public goods is reduced through federal deductibility. Each tax dollar a taxpayer (who itemizes) pays to a state or local government reduces the taxpayer's federal tax liability by an amount equal to his marginal tax rate multiplied by the taxes paid. Theoretically, state and local governments can levy higher taxes and provide more public goods than they would be able to absent federal deductibility. Through deductibility, state and local governments are also able to "export" part of their tax burden to all federal taxpayers, high-tax states more than others. Repeal of the AMT would expand the tax benefit generating more tax exportation. AMT reversion to pre-2001 rules would reduce the tax benefit and reduce tax exportation.

The variation of tax structures among states will lead to a significant differential impact by state and by individual. Generally, repeal of the AMT would *reduce* taxes for high-income taxpayers and reversion would *increase* taxes for high-income taxpayers. The highest-income taxpayers (adjusted gross income over $500,000), however, would not be affected because their regular income tax liability exceeds AMT liability.

Generally, high-tax, high-income states would fare relatively better under AMT repeal and relatively worse under reversion to pre-2001 AMT rules. This report includes a state-by-state breakdown of the average taxes paid deduction and the percentage of AMT filers and itemizers. This information is provided to help policymakers evaluate the effect of possible reforms on constituent governments.

This report analyzes the broad impact of the AMT and options for its modification. For information on congressional action with respect to the AMT, see CRS Report RS22100, *The Alternative Minimum Tax for Individuals: Legislative Initiatives and Their Revenue Effects,* by Gregg Esenwein.

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The alternative minimum tax (AMT) is a parallel tax to the regular individual income tax and is intended to help ensure that high-income individuals bear at least some tax liability.[1] The recent major tax cuts, however, lowered the average tax liability under the regular income tax such that many taxpayers could have been captured by the AMT, which is not indexed for inflation. Congress temporarily adjusted the AMT exemption amounts in 2001 (through the Economic Growth and Tax Relief Reconciliation Act, EGTRRA) and 2003 (through the Jobs and Growth Tax Relief Reconciliation Act, JGTRRA), and extended the temporary exemption amount increases in 2004 (through the Working Families Tax Relief Act, WFTRA).[2] By increasing the AMT exemption amount, the threshold where regular income tax liability falls below AMT liability is relatively higher, temporarily reducing the number of taxpayers subject to the AMT. In addition, some personal credits that were previously not allowed to offset AMT liability can now be used to offset the AMT.

Potential changes to the AMT would have a significant effect on the taxes levied on individuals and on the tax structure of state and local governments. Specifically, the distribution of the federal tax burden on individuals would change if either extreme, reversion to pre-2001 rules or repeal of the AMT, is implemented. State and local governments would either see the tax price for public goods increase (reversion) or decrease (repeal).

The report includes a state-by-state breakdown of the average "taxes paid deduction" and the percentage of AMT filers and itemizers. This information is provided to help policymakers evaluate the effect of possible reforms on constituent governments. The report concludes with a discussion of how congressional action on the AMT could affect state and local governments and taxpayers if Congress takes action dealing with the AMT in the 109th Congress.

Effect of the AMT on Individuals

The potential distributional effects of AMT reform or repeal on individuals is the focus of this section. There are two primary avenues through which the tax burden would be shifted: through the treatment of state and local taxes paid and

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[1] For more on the AMT, see CRS Report RL30149, *The Alternative Minimum Tax for Individuals*, by Gregg Esenwein.

[2] The WFTRA AMT extension is through the 2005 tax year.

through the distributional burden of the AMT generally. A secondary effect would arise as states and individuals respond to any new treatment of state and local taxes under the AMT or without an AMT. How the burden is currently distributed will help frame how burden would change under proposals to repeal or reform the AMT. **Table 1** provides a distribution of taxpayers based on the utilization of itemized deductions, the taxes paid deduction, and the presence of AMT tax liability. Generally, as adjusted gross income increases, so to does the prevalence of returns with itemized deductions, a taxes paid deduction, and AMT liability. Note that the vast majority of taxpayers with AGI greater than $100,000 itemize and claim a deduction for state and local taxes paid.

Table 1. Returns by Income Class, Selected Characteristics, 2003 Tax Year

Adjusted Gross Income Class	Returns in Income Class	Returns with Itemized Deductions	Returns with Taxes Paid Deduction	Returns with AMT Liability
less than $15,000	37,985,339	1,988,406	1,788,238	8,121
$15,001 to $30,000	29,738,980	4,735,954	4,449,624	4,113
$30,001 to $50,000	24,469,392	8,955,269	8,764,619	17,127
$50,001 to $100,000	26,935,410	17,779,740	17,631,775	187,913
$100,001 to $200,000	8,901,359	8,031,063	7,996,818	867,940
$200,001 and over	2,540,844	2,371,538	2,365,682	1,294,259
All Returns	130,571,319	43,861,971	42,996,756	2,379,473

Source: Internal Revenue Service, preliminary 2003 tax year data available online at [http://www.irs.ustreas.gov/pub/irs-soi/03in01er.xls].

Income Distribution of the State and Local Taxes Paid Deduction

Under the regular income tax, individuals who itemize deductions may deduct state and local taxes paid. Taxpayers must choose to deduct either income or sales taxes, not both.[3] In the 2003 tax year, 43.0 million returns deducted $307 billion in state and local taxes paid (see **Table 2**).[4] In contrast to the regular income tax treatment, under the alternative minimum tax (AMT) state and local taxes paid are considered a preference item and are included in the base of the tax. According to

[3] Under current law, the option to deduct sales taxes in lieu of income tax expires after 2005.

[4] The sales tax deduction option was not available in 2003; it became available for the 2004 tax year.

one estimate, approximately 2 million taxpayers "added back" approximately $42 billion in state and local taxes paid for purposes of calculating AMT tax liability.[5]

The taxes paid deduction is most common for returns in the higher income brackets. Out of the 11.4 million total returns with reported AGI of over $100,000, 10.4 million itemized deductions (see **Table 1**). The over $100,000 cohort of itemizing taxpayers represented 23.7% of itemized returns yet claimed 54.1% of the total taxes paid deduction (see **Table 2**). The highest income class represented 5.5% of returns yet accounted for 28.0% of the state and local taxes paid deduction.

Table 2. State and Local Taxes Paid Deduction by Income Class, 2003 Tax Year

Adjusted Gross Income Class	Returns with S&L Taxes Paid Deduction	Amount of Taxes Paid Deduction (in 000s)	Percentage of Taxes Paid Deduction Returns	Percentage of Taxes Paid Deduction
less than $15,000	1,788,238	$4,397,970	4.2%	1.4%
$15,000 to $30,000	4,449,624	$10,865,245	10.3%	3.5%
$30,001 to $50,000	8,764,619	$29,201,558	20.4%	9.5%
$50,001 to $100,000	17,631,775	$96,331,926	41.0%	31.4%
$100,001 to $200,000	7,996,818	$80,304,485	18.6%	26.1%
$200,001 and over	2,365,682	$86,001,720	5.5%	28.0%
All Returns	42,996,756	$307,102,902	100.0%	100.0%

Source: Internal Revenue Service, preliminary 2003 tax year data available online at [http://www.irs.ustreas.gov/pub/irs-soi/03in01er.xls].

As is often the case with federal tax policy, different parts of the tax code contradict one another. The treatment of state and local taxes is one example. The policy objective behind the tax preference for state and local taxes paid under the regular income tax has been supported with the claim that to disallow the deduction would amount to a "tax on a tax."[6] Proponents of the deduction suggest that taxes paid to state and local governments are not available to pay federal income taxes and thus should not be included in taxable income. In short, proponents of deductibility

[5] U.S. Department of Treasury, Office of Tax Analysis, unpublished data as cited by: Len Berman and David Weiner, "Suppose We Took the AM Out of the Alternative Minimum Tax," paper presented at the National Tax Association, 97th Annual Conference on Taxation, Nov. 11-13, 2004.

[6] See CRS Report RL32781, *Federal Deductibility of State and Local Taxes*, by Steven Maguire.

claim that "taxing a tax" is inequitable. If the AMT were to revert to the pre-2001 rules, this tax preference would be reduced, contravening the original intent of the tax deduction under the regular income tax.

However, if the taxes paid to state and local governments are viewed as payments for services (e.g., education services and garbage collection) some assert that a deduction for these taxes would not be justified. Reversion to pre-2001 AMT rules would be more consistent with this view. The characteristics of the goods and services provided by jurisdictions, in this view, determine the theoretical appropriateness of the deduction for the taxes used to pay for them. For example, consider jurisdiction "A" that provides foreign language classes and a government operated fitness center and jurisdiction "B" which does not offer either. If A funds these services with local property taxes, taxpayers (who itemize) are allowed to deduct the cost of these services through the federal deduction for state and local taxes paid. In contrast, taxpayers in jurisdiction B who purchase similar services, albeit from private providers, cannot deduct the expenditure. From a distributional perspective, jurisdictions that provide more services — likely wealthier jurisdictions — are able to export some of the burden to all federal taxpayers, including to those in poorer jurisdictions. Generally, the greater the likelihood of a private provider of a good or service, the less appropriate, some argue, is the federal deduction for the taxes used to fund those services.

The previous discussion touches on another justification for the deduction for state and local taxes: the indirect subsidy to state and local governments. The lower "tax price," theoretically, allows the local government to impose a tax rate that is higher than would be the case without deductibility.[7] For example, if a taxpayer is allowed to deduct property taxes, it is likely the case that these taxpayers would be more willing to accept a marginally higher property tax rate. For each dollar of property tax paid, the federal tax burden is reduced by the taxpayers marginal tax rate. A taxpayer in the 28% tax bracket would have federal tax liability reduced by 28 cents for each dollar paid in property taxes.

Economic theory predicts that more public services would be provided than would otherwise be the case without deductibility. The taxpayer has more disposable income (lower federal taxes), and thus would demand more public services. And, the relative price of government provided goods would decline, increasing the quantity of public goods demanded.[8]

From a state distributional perspective, high-tax, high-income states would benefit the most under expanded deductibility of state and local taxes, e.g., AMT repeal. This report provides a more detailed discussion of the effect on state and local governments of the taxes paid deduction under AMT reform (and repeal) proposals in a later section.

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[7] Douglas Holtz-Eakin and Harvey Rosen, "Federal Deductibility and Local Property Tax Rates," *Journal of Urban Economics*, vol. 27, 1990, pp. 269-284.

[8] Economists refer to these effects as the income and substitution effects, respectively.

Income Distribution of AMT Liability

The AMT affects considerably fewer taxpayers than the itemized deduction for state and local taxes paid (2.4 million returns vs. 43.0 million returns). The distribution of those affected by the AMT, however, is skewed to high-income returns to a much greater degree than is the taxes paid deduction. The aggregated data produced by the Internal Revenue Service (IRS) and summarized in **table 3** clearly exhibits the progressive nature of AMT liability; almost three-quarters of AMT liability in 2003 was paid by taxpayers with AGI over $200,000.

The IRS data, however, do not provide detailed information on taxpayers with AGI over $200,000. CBO testimony from May 2005, however, indicates that the share of taxpayers with AGI greater than $500,000 subject to the AMT will not change significantly when the AMT reverts to pre-2001 rules in 2006. In contrast, the share of taxpayers subject to the AMT in the $50,000 to $100,000 cohort and the $100,000 to $200,000 cohort will rise dramatically.[9] For these cohorts, the AMT rates are higher than the regular income tax rates. Taxpayers in the over $500,000 cohort encounter higher tax rates under the regular income tax than under the AMT and thus would not be affected by AMT reversion to pre-2001 rules.

Estimates of the anticipated AMT liability distribution if the current laws governing the AMT are not changed is a principal concern of many observers and policymakers. According to analysis from the Urban Institute — Brookings Tax Policy Center, under current law, taxpayers with AGI under $200,000 will pay almost 50% of AMT liability in 2010, almost twice the amount that group paid in 2003.[10] In addition, the same report estimates that the number of AMT taxpayers will increase to 29.2 million in 2010 from 2.4 million in 2003.[11] Although the AMT would still be relatively progressive in 2010, the increased burden on less wealthy taxpayers and the greater absolute number of taxpayers subject to the AMT, would diminish the overall progressivity of the federal tax system.

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[9] Douglas Holtz-Eakin, Congressional Budget Office Testimony, "The Individual Alternative Minimum Tax," before the Subcommittee on Taxation and IRS Oversight, Committee on Finance, U.S. Senate, May 23, 2005, figure 4, p. 6.

[10] Leonard Burman, William Gale, Mathew Hall, Jeffery Rohaly, and Mohammed Adeel Saleem, "The Individual Alternative Minimum Tax: A Data Update," Urban - Brookings Tax Policy Center, Washington D.C., Aug. 30, 2004.

[11] Burman, 2004.

Table 3. Income Distribution of AMT Liability, 2003 Tax Year

Adjusted Gross Income Class	Returns with AMT Liability	Amount of AMT Liability (in 000s)	Percentage of AMT Returns	Percentage of AMT Liability
less than $15,000	8,121	$48,329	0.3%	0.6%
$15,001 to $30,000	4,113	$26,825	0.2%	0.3%
$30,001 to $50,000	17,127	$20,359	0.7%	0.2%
$50,001 to $100,000	187,913	$235,844	7.9%	2.7%
$100,001 to $200,000	867,940	$1,894,654	36.5%	21.7%
$200,001 and over	1,294,259	$6,511,235	54.4%	74.5%
All Returns	2,379,473	$8,737,246	100.0%	100.0%

Source: Internal Revenue Service, preliminary 2003 tax year data available online at [http://www.irs.ustreas.gov/pub/irs-soi/03in01er.xls].

Effect of the AMT on State and Local Governments

This section describes and analyzes how possible congressional action on the AMT may affect state and local governments. Generally, under the AMT, state and local taxes paid do not receive a federal tax preference. In contrast, the repeal of the AMT combined with the scheduled repeal of the regular income itemized deduction phase-out would significantly increase the tax benefit conferred on states through deductibility.[12] For these reasons, state and local governments are actively following congressional action on the AMT.

State and local government representatives generally support the deductibility of state and local taxes under the regular income tax because of the indirect subsidy to sub-national governments delivered through a lower federal tax burden. Generally, state and local governments are able to "export" part of their tax burden to all federal taxpayers — some states more than others. Exporting the state and local tax burden can be measured by the amount of tax revenue that is deductible. The greater the amount of deductible taxes, the greater the exportation.

The recent tax cut legislation, the American Jobs Creation Act of 2004 (AJCA 2004), expanded the deductibility of the state and local taxes to include an option to

[12] Under current law, through 2009, certain high-income taxpayers are required to reduce itemized deductions (limited to up to 80% of allowable deductions). This itemized deduction reduction is phased out beginning in the 2006 tax year until completely repealed beginning in 2009.

deduct sales taxes *in lieu of* income taxes for taxpayers that itemize.[13] Taxpayers would choose the greater of sales taxes or income taxes when itemizing deductions. The new provision primarily benefits taxpayers in states that do not levy an income tax. The provision expires after 2005.

A variety of methods can be used to compare the relative tax burden of state and local taxes. For this report, state and local taxes that could have been deductible if AJCA 2004 rules were in place in 2002, was chosen as the instrument of comparison. The greater of sales taxes or income taxes was added to property taxes for each state. This amount was then divided by the number of 2002 tax returns filed in each state to produce an average amount for each state. The third column of **Table 4** presents these estimates of the average "deductible" taxes per return, by state. Note that because businesses pay a large portion of sales and property taxes, the averages overstate the burden on individual returns, yet the estimates are useful for comparative purposes.

Potentially deductible taxes (under the AJCA rules) would have been $6,596, on average, for returns filed in New York state; $2,349 in Alabama (see **Table 4**). The U.S. average was $3,985 per return.[14] Recall that state and local governments that rely more on deductible taxes pay a relatively lower "tax price" for public goods. Jurisdictions in New York state, for example, pay a lower tax price and export more of their tax burden to federal taxpayers than do jurisdictions in Alabama.

Table 4 also presents data on the percentage of AMT filers by state and the average state and local taxes paid deduction by state in FY2002. Note that the portion of itemizers will increase in 2004 and 2005 in the states that do not levy a broad-based income tax because of the option to deduct sales taxes *in lieu of* income taxes.[15] Taxpayers in states that do not levy an income tax will have a greater incentive to itemize and claim the deduction for taxes paid. The average taxes paid deduction will almost certainly rise in these states as existing itemizers simply add the sales tax paid to other itemized deductions. There are likely many taxpayers in these states who did not itemize before AJCA was enacted, but were relatively close to the threshold where itemized deductions could exceed the standard deduction.

It is important to emphasize that the IRS data in **Table 4** for 2003 are representative of tax returns filed before the sales tax deduction option was available.[16] Thus, taxpayers in states without a broad based income tax, Florida and Tennessee for example, would be more likely to itemize on 2004 tax returns when

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[13] For more, see CRS Report RL32455, *State and Local Sales Tax Deductibility: Legislation in the 108th Congress*, by Pamlea Jackson and Steven Maguire.

[14] Note that these estimates are considerably less than the standard deduction in 2002, $7,850 for married taxpayers and $4,700 for single taxpayers. This explains in part the relatively small number of taxpayers that itemize.

[15] See CRS Report RL32781, *Federal Deductibility of State and Local Taxes*, by Steven Maguire.

[16] For more on the sales tax deductibility, see CRS Report RL32781, *Federal Deductibility of State and Local Taxes*, by Steven Maguire.

the sales tax deduction option was available than in 2003. For example, according to the tables in IRS Publication 600, the *state* sales tax deduction for a family of four in Tennessee with income between $100,000 and $120,000, would have been $1,496 in 2004. In addition, this family could deduct another $588 for *local* sales taxes paid. Further, if this family had purchased a $20,000 car (or boat), they could deduct another $1,975. In sum, this Tennessee family could have deducted an additional $4,059 under the sales tax deduction option. With the standard deduction for joint filers at $9,700 in 2004, it seems reasonable to assume that the additional sales tax deduction would have induced itemizing for many taxpayers in a similar situation.

The data from the U.S. Census Bureau in the third column of **Table 4** include the property tax and either the sales tax or income tax. The tax which generates the most revenue was added to the property tax to simulate a state's reliance on deductible taxes under 2004 and 2005 tax rules. Comparing states based on what current law would allow seems to be a reasonable proposition. In addition, the percentage of itemizers would likely be higher in 2004 and 2005 in those states without an income tax.

States without a broad based state income tax are indicated by an asterisk. Note that unlike other states, almost all these states have an average amount of potentially deductible taxes that is greater than the average actual taxes paid deduction.

Table 4. AMT Filers and the Average Taxes Paid Deduction on Federal Income Tax Returns

State (* indicates no broad-based state income tax)	AMT Filers as Percentage of all Returns (2003)	Total Property, Income or Sales Taxes per Return Filed (2002)	Percentage of Filers Itemizing Deductions (2003)	Average State and Local Taxes Paid Deduction (2003)
U.S. Average	1.41%	$3,985	33.81%	$5,874
Alabama	0.52%	$2,349	31.09%	$3,624
Alaska*	0.49%	$2,858	25.74%	$2,864
Arizona	0.90%	$4,565	39.16%	$4,816
Arkansas	0.79%	$3,167	25.23%	$4,883
California	3.13%	$4,208	39.17%	$8,884
Colorado	1.11%	$3,935	42.38%	$5,293
Connecticut	3.68%	$5,756	43.66%	$10,424
Delaware	1.18%	$3,055	37.69%	$5,492
District of Columbia	3.27%	$6,295	40.54%	$9,234
Florida*	0.91%	$4,034	29.75%	$3,707
Georgia	1.45%	$3,865	39.14%	$5,960
Hawaii	1.11%	$3,858	33.79%	$5,299
Idaho	1.07%	$3,197	36.94%	$5,135
Illinois	1.41%	$4,050	36.31%	$6,475
Indiana	0.71%	$3,575	32.63%	$5,192
Iowa	0.95%	$3,656	33.26%	$5,717
Kansas	1.19%	$3,930	32.10%	$6,230
Kentucky	1.06%	$3,119	32.16%	$6,028
Louisiana	0.69%	$3,603	22.10%	$3,523
Maine	1.52%	$4,872	32.36%	$7,301
Maryland	2.90%	$5,042	48.88%	$7,944
Massachusetts	2.92%	$5,326	40.63%	$8,655
Michigan	1.14%	$3,834	37.97%	$6,099
Minnesota	1.92%	$4,469	42.45%	$6,804
Mississippi	0.53%	$3,427	23.68%	$3,966
Missouri	1.02%	$3,166	32.29%	$5,768
Montana	1.04%	$3,210	32.40%	$5,296
Nebraska	1.26%	$3,768	31.13%	$6,591
Nevada*	0.79%	$4,002	36.74%	$2,904
New Hampshire*	1.28%	$3,524	36.36%	$6,126
New Jersey	4.38%	$5,609	44.67%	$10,003
New Mexico	0.87%	$2,967	27.64%	$5,076
New York	4.15%	$6,596	38.96%	$11,098
North Carolina	1.45%	$3,476	37.59%	$6,252
North Dakota	0.56%	$3,078	20.03%	$4,471
Ohio	1.78%	$4,047	35.37%	$6,721
Oklahoma	0.84%	$2,776	30.32%	$5,133

State (* indicates no broad-based state income tax)	AMT Filers as Percentage of all Returns (2003)	Total Property, Income or Sales Taxes per Return Filed (2002)	Percentage of Filers Itemizing Deductions (2003)	Average State and Local Taxes Paid Deduction (2003)
Oregon	1.85%	$4,333	42.38%	$7,222
Pennsylvania	1.37%	$3,527	32.61%	$6,548
Rhode Island	2.13%	$4,592	37.35%	$8,259
South Carolina	1.08%	$3,075	33.54%	$5,629
South Dakota*	0.43%	$3,778	18.08%	$2,778
Tennessee*	0.42%	$3,639	24.01%	$2,161
Texas*	0.74%	$4,662	23.77%	$4,288
Utah	1.03%	$3,556	41.63%	$5,089
Vermont	1.61%	$4,071	32.47%	$6,926
Virginia	1.79%	$3,989	40.82%	$6,666
Washington*	0.65%	$5,394	35.48%	$3,262
West Virginia	0.62%	$2,578	19.00%	$5,325
Wisconsin	1.57%	$4,416	39.42%	$7,692
Wyoming*	0.63%	$5,335	21.29%	$2,761

Source: Internal Revenue Service, Census of Governments 2001-2002, and CRS calculations.

Potential Issues for Congress

Congress might ultimately choose one of three basic approaches to address the AMT. The first is to allow the AMT to revert to the pre-2001 rules. If no action is taken on the AMT in 2005, the reversion would occur beginning with the 2006 tax year. The second approach is continued modification of the AMT to capture roughly the same number of taxpayers every year. This would require annual adjustment of the higher AMT exemption amounts through indexation or a similar process. Thirdly, the AMT could be repealed outright. (H.R. 1186 and S. 1103 introduced in the 109th Congress would repeal the AMT.)

If the AMT is repealed, federal revenue will decline considerably as current budget forecasts predict repeal would generate a $611 billion revenue loss over the 2006-2015 budget window, assuming the EGTRRA and JGTRRA tax cuts are **not** extended.[17] If the other regular income tax cuts are extended **and** the AMT is repealed, the federal revenue loss over the same budget window would be approximately $1.16 trillion.[18]

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[17] Holtz-Eakin, Douglas, Congressional Budget Office Testimony, "The Individual Alternative Minimum Tax," before the Subcommittee on Taxation and IRS Oversight, Committee on Finance, U.S. Senate, May 23, 2005, p. 8.

[18] U.S. Department of Treasury, *Fact Sheet: A Tale of Two Taxes, Regular Income Tax and*
(continued...)

The second option, extension of the highest AMT exemption and indexation, would essentially maintain the status quo and would not significantly shift the burden of federal taxation among the states. But, because current law does not index the AMT, the cost of indexation under this option (beginning with the higher AMT exemption amounts) would be $385 billion over the 2006-2015 budget window assuming the regular income tax cuts are *not* extended.[19] If the tax cuts are extended, the cost of this proposal would rise to $642 billion.[20] (H.R. 703 would index the AMT exemption amount and would allow state and local taxes paid to be deducted from the AMT base.) In contrast to indexation, the two extremes, reversion and repeal, would likely have significant impact on state and local governments and would significantly alter the burden of federal taxation. For a discussion of the revenue cost of various reform options for the AMT, see CRS Report RS22100, *The Alternative Minimum Tax: Legislative Initiatives and Their Revenue Effects*.

AMT Reversion to Pre-2001 Rules

If the AMT is allowed to revert to the structure in place before 2001, and the regular income tax cuts (EGTRRA and JGTRRA) are made permanent, then the role of state and local taxes in determining federal tax liability will change significantly. Under this scenario, the AMT would capture many more taxpayers as regular income tax liability falls below the floor established by the AMT. State and local taxes paid, as noted earlier, would become taxable, reducing the implicit federal transfer to state and local governments. Because the deduction for state and local taxes paid varies by state, so too will the impact of AMT adjustments.

For example, the average taxes paid itemized deduction for filers residing in New York was $11,098 in 2003 whereas in Florida, the average taxes paid itemized deduction was $3,707 (see **Table 1**). The reason for the disparity arises from the following two factors: the level of state and local taxes and the average income in the state. Generally, higher state and local taxes and higher income would both contribute to a higher likelihood of itemizing and claiming a deduction for state and local taxes paid.

States with the highest average amount of state and local taxes deducted (New York, Connecticut, New Jersey, District of Columbia, California, Massachusetts, and Rhode Island are the top seven) would be the most negatively affected if the AMT is allowed to revert to pre-2001 rules. In contrast, states with relatively low taxes paid deductions, (Tennessee, Wyoming, South Dakota, Alaska, Nevada, and Washington) would be the least negatively affected. Note that these states are also states without broad based income taxes. If the AJCA 2004 sales tax deduction

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[18] (...continued)
the AMT, March 2, 2005.

[19] Holtz-Eakin, Douglas, Congressional Budget Office Testimony, "The Individual Alternative Minimum Tax," before the Subcommittee on Taxation and IRS Oversight, Committee on Finance, U.S. Senate, May 23, 2005, Table 1, p. 8.

[20] Congressional Budget Office, *The Budget and Economic Outlook: Fiscal Years 2006 to 2015*, January 2005, p. 8.

option were extended beyond 2005, reversion to pre-2001 AMT rules would have a greater negative impact on these states. The burden of federal taxes would shift from the low tax states to the high tax states if the AMT reverts unchanged to pre-2001 rules.

Repeal of the AMT

In contrast to allowing the AMT to revert to pre-2001 rules, Congress could repeal the AMT and state and local governments would continue to receive an indirect benefit through deductibility of state and local taxes. The elimination of the phase-out of itemized deductions under the regular income tax in 2009 would also enhance the taxpayer benefit derived from deducting state and local taxes.

If the AMT is repealed, the loss in revenue would necessarily result in one or more of the following: greater federal debt, an increase in other federal taxes, and/or reduced federal spending. If federal debt is increased, the cost of borrowing for both the government and the private sector, will also increase. State and local governments, which typically rely on debt to fund public infrastructure, such as schools, roads, and bridges, would likely face higher interest costs as the supply of all types of government bonds expands. The long-run drag on the economy generated by government dissaving, however, could be partially offset by the short-term stimulative effect of lower taxes.

The impact of increasing other federal taxes to replace the lost AMT revenue depends on the tax raised and how the tax is increased. If the base of the regular federal income tax (personal or corporate) is expanded, e.g., the elimination of special deductions or exclusions, many states could receive a slight windfall. A windfall arises because most states use the base of the federal income tax (both individual and corporate) as the starting point for state income taxes. For this reason, if state and local tax rates remain constant, the expanded federal base would increase state and local tax revenue. Alternatively, an increase in federal rates or the elimination of lower tax brackets would have little effect on most state income tax revenue. Other federal tax changes, such as changes in excise taxes, would likely have little direct effect on the state and local government finances.

Spending cuts would likely include some reduction in grants-in-aid to state and local governments. These grants comprised approximately 15% ($350.4 billion) of total federal government current expenditures in 2004.[21] In addition, cuts in federal spending, other than direct grants, may also adversely affect states if states must increase spending to provide what was once provided by the federal government.

Many observers predict that the AMT will be modified during the 109th Congress. In addition, proposals addressing fundamental tax reform could include reform of the AMT. The direction of any congressional choice would have a significant and varied impact on taxpayers and on state and local governments.

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[21] *Economic Report of the President*, Feb. 2005, Table B-82, p. 307.