Order Code RS21817
Updated March 5, 2008

CRS Report for Congress

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The alternative minimum tax for individuals (AMT) was originally enacted to ensure that high-income taxpayers paid a fair share of the federal income tax.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

Temporary increases in the AMT exemption amounts expired at the end of 2007. If this occurs, then the number of taxpayers subject to the AMT will jump from roughly 5 million in 2007 to 26 million in 2008. Taxpayers filing joint returns with no dependents will be subject to the AMT starting at income levels of $74,660. Large families will be subject to the AMT at income levels as low as $55,568.

In addition, for many taxpayers, the AMT will "take back" much of the reductions in the regular income tax earlier this decade.

The estimated combined revenue loss from extending recent reductions in the regular individual income tax and extending the higher AMT exemption amounts (indexed for inflation) and allowing personal credits (the "patch") would be significant. These two policy options together along with increased debt service would reduce federal tax revenues by more than $4.3 trillion between 2009 and 2018.

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.

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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 Steven Maguire.

There are two main reasons for the increase in the number of taxpayers affected by the AMT. First, tax reductions under the regular income tax have significantly 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), the Jobs and Growth Tax Relief Reconciliation Act of 2003 (P.L. 108-27; JGTRRA), and the Working Families Tax Relief Act of 2004 (P.L. 108-311; WFTRA). In addition to reducing taxes under the regular income tax, all of these measures 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, expired at the end of 2007.

Second, the regular income tax is indexed for inflation but the AMT is not. Over time this has further reduced 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.

The combination of these two factors — reductions in the regular income tax and the lack of AMT indexation — 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 2007, about 5 million taxpayers will pay the AMT. If the temporary AMT exemption increase is not extended beyond 2007, then about 26 million taxpayers will pay the AMT in 2008. By 2017, if the tax cuts are extended, then the number of taxpayers paying the AMT will increase to almost 36 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 state and local tax deductions, personal exemptions, and miscellaneous itemized deductions. These three items account for over 96% 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.

This grossed up income becomes the tax base for the AMT. An exemption of $66,250 for joint returns and $44,350 for single and head of household returns is subtracted to obtain AMT taxable income for 2007. (These exemption levels are temporary and are scheduled to revert in 2008 to their prior law levels of $45,000 for joint returns and $35,750 for unmarried taxpayers.) The basic AMT exemption is phased out

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[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 allow taxpayers to use personal tax credits against both their regular and AMT liabilities expired at the end of 2007. 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. Congress, Joint Committee on Taxation, "Present Law and Background Relating to the Alternative Minimum Tax," JCX-38-07, June 25, 2007.

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.

Structural Overlap of the AMT with the Regular Income Tax

The reductions in the regular income tax and the lack of AMT indexation means that in 2008 when the temporary increases in the AMT exemption expire there will be a structural overlap between the AMT and the regular income tax. Over certain income intervals, individuals will be subject to the AMT rather than the regular income tax.

Table 1 below shows the income levels at which joint returns with up to six children would be subject to the AMT rather than the regular income tax in 2008. That is, it shows the income intervals 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]

For example, in 2008 taxpayers filing joint returns with two children and income between $65,114 and $457,239 will be subject to the AMT rather than the regular income tax. For larger families, the AMT will overlap the regular income tax at lower incomes and extend through higher incomes. For families with four children, the AMT is greater than the regular income tax for joint returns with incomes between $55,568 and $480,572.

Table 1. 2008 Income Boundaries Where Joint Taxpayers Will Be Subject to the AMT Rather than the Regular Income Tax

	Number of Children				
	None	**1**	**2**	**3**	**4**
Entry point	$74,660	$69,887	$65,114	$60,341	$55,568
Exit point	$433,905	$445,575	$457,239	$468,905	$480,572

Note: Calculated by CRS. Assumes income is all earned income, the use of the standard deduction, and that the families have no AMT preference items other than their personal exemptions.

"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 tax cuts will be lost if the AMT exemption amount for joint returns reverts back to $45,000 in 2008. For example, consider the case of a joint return with two children and an income of $75,000. If the tax cuts had not been enacted, then their regular income tax liability in 2008 would have been $6,515. Their AMT tax liability in 2008 under current law will be $5,800. Since their AMT would have been less than their

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[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**.

regular income tax liability (absent the tax cuts), they would pay their regular income tax of $6,515.

However, under current law (which includes the effects of the tax cuts) this family's regular income tax liability in 2008 will be $4,713. This represents a $1,802 reduction in their regular income tax compared to what it would have been under pre-2001 tax law. Their AMT liability in 2008 will still be $5,800 — permanent AMT modifications were not included in the tax cut. Since their AMT liability is higher than their regular income tax in 2008, they would pay the AMT of $5,800. In essence, the AMT takes back $1,087 of the tax reductions (the difference between the family's regular income tax liability of $4,713, and their $5,800 AMT liability). So, 60% of the reduction in their regular income taxes will be lost to the AMT ($1,087 in realized tax reductions divided by $2,045 in potential tax reductions).

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

2008 Income Levels	2008 Income Taxes Assuming Pre-2001 Tax Law (No Tax Cut)	Current Law for 2008		AMT Take Back of Enacted Tax Cuts	Percentage of Tax Cut Lost to AMT
		Regular Income Tax (w/ Tax Cut)	AMT		
$75,000	$6,515	$4,713	$5,800	$1,087	60.3%
$90,000	$8,801	$6,963	$9,700	$2,737	148.9%
$100,000	$11,601	$9,463	$12,300	$2,837	132.7%
$120,000	$17,701	$14,963	$18,000	$3,037	110.9%
$150,000	$26,601	$23,963	$27,300	$3,337	126.5%
$175,000	$33,601	$30,772	$35,425	$4,653	164.5%
$200,000	$41,153	$37,772	$43,550	$5,778	170.9%

Note: Calculated by CRS. Assumes earned income, use of standard deduction, and that the only personal tax credits claimed are the child tax credit (which is phased out beginning at income greater than $110,000).

In dollar terms, the take back increases as income increases through. In these examples the family hardest hit by the AMT has $200,000 of income. Under pre-tax-cut law, their regular income tax liability in 2008 would have been $41,153. With the tax cuts, their regular income tax would fall to $37,772, a reduction of $3,381. The AMT liability, however, would be $43,550, effectively taking back the entire tax cut plus an additional $2,397. Without a patch or repeal of the AMT, a family of four with $200,000 of income will actually pay more in taxes in 2008 than if the tax cuts were never implemented. In fact, CRS calculates that most families of four filing a joint return with income greater than $81,500 would pay more in 2008 — because of the AMT — than if the tax cuts were never implemented.

Revenue Costs of Fixing the AMT

The revenue costs of fixing the AMT are substantial. It is estimated that the AMT will raise almost $107 billion in revenue in FY2009.[5] By 2018, it will bring in $130 billion in revenue. Outright repeal of the AMT, thus, would be expensive. Estimates indicate that repeal of the AMT would reduce federal tax revenues by $759.2 billion from FY2009 through FY2017, assuming the EGTRRA/JGTRRA tax cuts expire as scheduled in 2010. If these tax cuts are extended, then the cost of AMT repeal could rise to well over $1.4 trillion.[6]

Other less costly options include allowing state and local tax deductions against the the AMT, and extending/indexing the recent increase in the AMT exemption. As shown in **Table 3**, however, even these options are relatively expensive. For instance, allowing state and local tax deductions against the AMT would cost $501 billion between FY2009 and FY2017. Extending and indexing the recent increase in the AMT exemption would reduce federal revenues by $613.0 billion over the same period.

Table 3. Costs of Selected AMT Modifications, FY2009 to FY2017
(billions of dollars)

	2009	2010	2011	2012	2013	2014	2015	2016	2017	Total
Allow State and Local Tax Deduction Against AMT[a]	62.1	70.2	58.5	34.8	40.9	47.4	54.3	62.2	70.6	501.0
Extend Increased AMT Exemption with Indexation[b]	75.0	76.0	71.0	42.0	49.0	58.0	68.0	80.0	94.0	613.0
Repeal the AMT[a]	96.3	112.2	93.9	51.4	60.2	69.4	79.5	91.5	104.8	759.2

Assumes 2001/2003 tax cuts expire at the end of calender year 2010.

a. U.S. Congress, Joint Committee on Taxation, "Present Law and Background Relating to the Alternative Minimum Tax," JCX-38-07, June 25, 2007.
b. Congressional Budget Office, *The Budget and Economic Outlook: Fiscal Years 2008 to 2018*, Jan. 2008. The loss estimate does not include the expected higher cost of debt service and assumes the increased exemption levels set in 2007 increase with inflation. The inclusion of the debt service would add $189 billion to the revenue loss. The CBO estimates that in 2018, the provision will cost another $110 billion (with $40 billion in additional interest expense).

If the recent reductions in the regular income tax are extended beyond their scheduled sunset date of December 31, 2010, then the costs of each of the three AMT modifications shown in the table above would grow considerably. For instance, CBO estimated that if the tax cuts are extended, then the cost of extending and indexing the increased AMT exemption combined with allowing personal tax credits against the AMT

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[5] Congressional Budget Office, *The Budget and Economic Outlook: Fiscal Years 2008 to 2018*, January 2008.

[6] Urban-Brookings Tax Policy Center. *The Individual Alternative Minimum Tax: Historical Data and Projections*, November 2006.

would cost roughly $4.3 trillion over the FY2009 through FY2018 period (including the increased debt service payments if the change is financed with debt).[7]

[7] Congressional Budget Office, *The Budget and Economic Outlook: Fiscal Years 2008 to 2018*, January 2008.