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State and Local Taxes and the Federal Alternative Minimum Tax

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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 2001 and 2003 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 the 2008 tax year 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describes the potential impact on taxpayers and state and local governments if the AMT reverts to pre-2001 rules or is repealed.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. Most of 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 of the AMT 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 RL34382, *The Alternative Minimum Tax For Individuals: Legislative Activity in the 110th Congress*, by Steven Maguire and Jennifer Teefy.

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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 2001 and 2003 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 exemption amounts have been increased several times beginning in 2001. 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). Congress extended the temporary exemption amount increases in 2004 (through the Working Families Tax Relief Act, WFTRA) and again in 2006 (the Tax Increase Prevention and Reconciliation Act of 2005, TIPRA).[2] The Tax Increase Prevention Act of 2007 (TIPA) increased the exemption levels and extended the allowance of personal credits against the AMT for the 2007 tax year. 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 2008.

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

[2] The WFTRA AMT extension is through the 2005 tax year. The TIPRA extension is through the 2006 tax year.

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 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 for all returns, for the 2006 tax year. The AMT "patch" for 2006 kept the number of AMT filers under 4 million.

Table 1. Returns by Income Class, Selected Characteristics, 2006 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 $5,000	14,308,964	345,274	322,484	7,641
$5,000 to $10,000	11,786,747	577,704	551,708	2,336
$10,000 to $15,000	11,711,680	1,029,474	980,400	850
$15,000 to $20,000	10,937,694	1,276,531	1,232,624	2,202
$20,000 to $25,000	9,912,261	1,536,608	1,498,621	2,668
$25,000 to $30,000	8,749,761	1,821,779	1,766,088	1,513
$30,000 to $40,000	14,151,824	4,363,179	4,471,818	3,811
$40,000 to $50,000	10,687,193	4,546,362	4,494,623	7,815
$50,000 to $75,000	18,854,917	10,818,922	10,761,866	87,680
$75,000 to $100,000	11,140,408	8,297,996	8,281,651	129,240
$100,000 to $200,000	12,088,423	10,655,930	10,642,872	1,096,666
$200,000 to $500,000	3,121,485	2,962,237	2,960,017	2,242,146
$500,000 to $1,000,000	589,306	552,797	551,385	269,527*
$1,000,000 to $1,500,000	150,431	142,284	142,087	40,938*
$1,500,000 to $2,000,000	64,007	61,068	60,950	16,710*
$2,000,000 to $5,000,000	98,724	95,326	95,169	24,043*
$5,000,000 to $10,000,000	24,975	24,348	24,299	6,518*
$10,000,000 and over	15,956	15,735	15,696	4,632*
All Returns	138,394,754	49,123,555	48,660,923	3,966,540

Source: IRS, Statistics of Income, *Individual Complete Report 2006*, Publication 1304, July 2008.

* The number of filers for these income groups is the number of *itemizers* with AMT liability, which is slightly less than total AMT filers for these groups. IRS Publication 1304 does not provide the total number for all AMT filers for these income groups. There are 19,604 AMT filers not accounted for in the AGI groups listed here. They are likely concentrated in the $500,000 to $1 million cohort.

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 $75,000, itemize and claim a deduction for state and local taxes paid.

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, before the sales tax deduction option was available, 43.1 million returns deducted $310.9 billion in taxes paid.[4] In the 2004 tax year, the first year for the sales tax deduction option, 46.0 million returns deducted $362.6 billion.[5] In the 2005 tax year, 47.4 million returns deducted $400.4 billion.[6] And, in 2006, 48.7 million deducted $432.8 billion.[7] The increase in number of returns claiming the taxes paid deduction and in the amount deducted is likely due in part to the sales tax deduction option. 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 the Joint Committee on Taxation (JCT), approximately 4 million taxpayers "added back" approximately $90.9 billion in state and local taxes paid for purposes of calculating AMT liability in 2006.[8]

The taxes paid deduction is most common for returns in the higher income brackets. Out of the 27.3 million total returns with reported AGI of over $75,000, 22.8 million itemized deductions (see **Table 1**). Itemized returns with AGI over $75,000 represented 46.4% of itemized returns and claimed 75.7% of the total taxes paid deduction (see **Table 2**). Itemized returns with AGI over $100,000 represented 29.5% of itemized returns yet accounted for 62.8% of the taxes paid deduction.

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

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[3] Under current law, the option to deduct sales taxes in lieu of income tax expired at the end of 2007.

[4] Internal Revenue Service (IRS), Statistics of Income, *Individual Complete Report 2003*, Publication 1304, Oct. 2005. The sales tax deduction option was not available in 2003; it became available for the 2004 tax year.

[5] IRS, Statistics of Income, *Individual Complete Report 2004*, Publication 1304, Sept. 2006.

[6] IRS, Statistics of Income, *Individual Complete Report 2005*, Publication 1304, July 2007.

[7] IRS, Statistics of Income, *Individual Complete Report 2006*, Publication 1304, July 2008.

[8] U.S. Congress, Joint Committee on Taxation, "Present Law and Background Relating to the Alternative Minimum Tax," JCX-38-07, June 25, 2007.

would amount to a "tax on a tax."[9] 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 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. In a recent analysis, if not for the patch, the AMT would have reduced the "value" of the taxes paid deduction by over one-quarter.[10] The analysis also estimated the lower tax rates enacted in 2001 and 2003 further diminished the "value" of the deduction by roughly 20%.

Table 2. Taxes Paid Deduction by Income Class, 2006 Tax Year

Adjusted Gross Income Class	Returns with Taxes Paid Deduction	Amount of Taxes Paid Deduction (in $ 000s)	Percentage of Taxes Paid Deduction Returns	Percentage of Taxes Paid Deduction Amount
less than $5,000	322,484	1,091,230	0.7%	0.3%
$5,001 to $10,000	551,708	1,530,443	1.1%	0.4%
$10,000 to $15,000	980,400	2,461,698	2.0%	0.6%
$15,000 to $20,000	1,232,624	3,391,832	2.5%	0.8%
$20,000 to $25,000	1,498,621	4,168,222	3.1%	1.0%
$25,000 to $30,000	1,766,088	5,227,676	3.6%	1.2%
$30,000 to $40,000	4,278,384	14,401,327	8.8%	3.3%
$40,000 to $50,000	4,494,623	17,811,669	9.2%	4.1%
$50,000 to $75,000	10,761,866	54,984,402	22.1%	12.7%
$75,000 to $100,000	8,281,651	55,727,801	17.0%	12.9%
$100,000 to $200,000	10,642,872	111,054,876	21.9%	25.7%
$200,000 to $500,000	2,960,017	64,770,705	6.1%	15.0%
$500,000 to $1,000,000	551,385	27,064,821	1.1%	6.3%
$1,000,000 to $1,500,000	142,087	11,483,609	0.3%	2.7%
$1,500,000 to $2,000,000	60,950	7,079,805	0.1%	1.6%
$2,000,000 to $5,000,000	95,169	17,761,193	0.2%	4.1%
$5,000,000 to $10,000,000	24,299	10,024,660	0.0%	2.3%
$10,000,000 and over	15,696	22,738,131	0.0%	5.3%
All Returns	48,660,923	432,774,100	100.0%	100.0%

Source: IRS, Statistics of Income, *Individual Complete Report 2006*, Publication 1304, July 2008.

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

[10] Gilbert Metcalf, "Assessing the Federal Deduction for State and Local Tax Payments," *National Bureau of Economic Research*, Working Paper 14023, May 2008.

In contrast, 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. Alternatively, 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 (jurisdiction "A" in our example) — 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.[11] 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 taxpayer's 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.[12] 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.[13]

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

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

[12] An alternative view of the property tax is that the tax acts as a tax on capital. The higher capital taxes would in turn discourage business capital investment. In theory, business capital would flee the high tax jurisdictions, ultimately lowering tax receipts. Thus, it is argued, local governments may rely less on the property tax and actually *invest less* in public goods and services to avoid business flight to other jurisdictions. Total local government investments in public goods and services, in turn, is lower than it otherwise would be absent the property tax.

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

local governments of the taxes paid deduction under AMT reform (and repeal) proposals in a later section.

Income Distribution of AMT Liability

The AMT affects considerably fewer taxpayers than the itemized deduction for taxes paid; 4.0 million and 49.1 million, respectively, in 2006. The distribution of those affected by the AMT, however, is more concentrated than the taxes paid deduction. The aggregated data produced by the Internal Revenue Service (IRS) and summarized in **Table 3** and **Table 4** clearly exhibit the concentrated (and progressive) nature of AMT liability; roughly 84.1% of AMT returns reported AGI between $100,000 and $500,000.

Table 3. Income Distribution of Returns with AMT Liability, 2004 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 $5,000	4,762	$88,815	0.2%	0.7%
$5,001 to $10,000	35	612	0.0%	0.0%
$10,000 to $15,000	3,082	1,782	0.1%	0.0%
$15,000 to $20,000	1,672	3,386	0.1%	0.0%
$20,000 to $25,000	972	1,537	0.0%	0.0%
$25,000 to $30,000	1,339	1,171	0.0%	0.0%
$30,000 to $40,000	1,664	448	0.1%	0.0%
$40,000 to $50,000	11,818	19,019	0.4%	0.1%
$50,000 to $75,000	89,396	116,192	2.9%	0.9%
$75,000 to $100,000	155,065	224,349	5.0%	1.7%
$100,000 to $200,000	1,095,242	2,058,479	35.4%	15.8%
$200,000 to $500,000	1,529,159	6,831,014	49.4%	52.4%
$500,000 to $1,000,000	149,042	1,645,295	4.8%	12.6%
$1,000,000 to $1,500,000	24,574	452,148	0.8%	3.5%
$1,500,000 to $2,000,000	9,720	257,229	0.3%	2.0%
$2,000,000 to $5,000,000	13,423	538,675	0.4%	4.1%
$5,000,000 to $10,000,000	3,258	269,065	0.1%	2.1%
$10,000,000 and over	2,077	520,024	0.1%	4.0%
All Returns	3,096,299	13,029,239	100.0%	100.0%

Source: IRS, Statistics of Income, *Individual Complete Report 2004*, Publication 1304, September 2006.

Because regular income tax liability increases as income increases, eventually surpassing AMT tax rates, the share of taxpayers with AGI greater than $500,000 subject to the AMT would not change significantly if the AMT reverts to pre-2001 rules. 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 would rise dramatically. 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.

Table 4. Income Distribution of Returns with AMT Liability, 2006 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 $5,000	7,641	187,200	0.2%	0.9%
$5,001 to $10,000	2,336	316	0.1%	0.0%
$10,000 to $15,000	850	1,138	0.0%	0.0%
$15,000 to $20,000	2,202	3,649	0.1%	0.0%
$20,000 to $25,000	2,668	2,880	0.1%	0.0%
$25,000 to $30,000	1,513	11,746	0.0%	0.1%
$30,000 to $40,000	3,811	11,993	0.1%	0.1%
$40,000 to $50,000	7,815	17,190	0.2%	0.1%
$50,000 to $75,000	87,680	105,899	2.2%	0.5%
$75,000 to $100,000	129,240	180,430	3.3%	0.8%
$100,000 to $200,000	1,096,666	2,128,778	27.6%	9.9%
$200,000 to $500,000	2,242,146	10,982,445	56.5%	50.9%
$500,000 and over	381,972	7,930,923	9.6%	36.8%
All Returns	3,966,540	21,564,586	187,200	100.0%

Source: IRS, Statistics of Income, *Individual Complete Report 2006*, Publication 1304, July 2008.

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 Joint Committee on Taxation (JCT), under current law, taxpayers with AGI under $200,000 will pay almost 48% of AMT liability in 2010, compared to less than 13% that the group paid in 2006.[14] In addition, the same analysis estimates that the number of AMT taxpayers will increase

[14] U.S. Congress, Joint Committee on Taxation, "Present Law and Background Relating to the Alternative Minimum Tax," JCX-38-07, June 25, 2007. Since this JCT publication, actual data for 2006 have been released and these data are used instead of the JCT estimates.

to 30.9 million in 2010 from 4.0 million in 2006. 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.

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.[15] 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.

Tax cut legislation, the American Jobs Creation Act of 2004 (AJCA 2004, P.L. 108-357), expanded the deductibility of the state and local taxes to include an option to deduct sales taxes *in lieu of* income taxes for taxpayers that itemize.[16] Taxpayers 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 expired after 2007.

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 under AJCA 2004 rules were 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 2006 tax returns filed in each state to produce an average amount for each state. The third column of **Table 5** 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.

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[15] 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.

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

Potentially deductible taxes (under the AJCA rules) would have been $8,372, on average, for returns filed in New York state; $2,844 in Alabama (see **Table 5**). The U.S. average was $4,606 per return.[17] 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 5. 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 2006	Total Property, Income or Sales Taxes per Return Filed 2006	Percentage of Filers Itemizing Deductions 2006	Average Taxes Paid Deduction 2006
United States	**2.96%**	**4,606**	**35.62%**	**9,595**
New York	5.50%	8,372	38.40%	17,589
California	4.60%	5,532	39.74%	14,481
Connecticut	5.65%	7,785	45.21%	13,773
New Jersey	6.47%	7,342	45.28%	13,673
District of Columbia	5.22%	8,501	42.49%	12,136
Massachusetts	4.57%	6,778	41.86%	11,217
Maryland	4.68%	5,818	50.14%	10,308
Rhode Island	3.04%	5,625	37.89%	10,042
Virginia	3.54%	5,059	41.74%	9,984
Illinois	2.68%	4,786	36.68%	9,322
Oregon	2.88%	5,440	41.73%	9,199
Wisconsin	2.25%	5,088	38.35%	9,024
Vermont	2.49%	5,297	31.20%	8,957
Maine	2.21%	5,646	32.12%	8,772
Minnesota	2.90%	4,768	41.42%	8,685
Ohio	2.51%	4,775	34.77%	8,648
Pennsylvania	2.53%	4,394	32.35%	8,577
Nebraska	2.03%	4,658	31.47%	8,375
Kansas	2.14%	4,734	31.30%	8,275
North Carolina	2.47%	4,107	36.90%	7,960
New Hampshire	2.26%	4,329	37.42%	7,564
Texas	1.79%	5,452	26.20%	7,460
Georgia	2.51%	4,524	39.45%	7,247
Delaware	2.34%	3,901	37.81%	7,244
Michigan	1.91%	4,641	36.74%	7,141
Hawaii	2.10%	5,230	33.61%	7,125
Kentucky	1.55%	3,479	31.29%	7,116
Missouri	1.78%	3,645	31.76%	7,107
South Carolina	1.93%	3,717	33.27%	7,030
Idaho	1.97%	3,840	35.61%	6,984
Colorado	2.37%	4,518	42.16%	6,844

[17] Note that these estimates are considerably less than the standard deduction in 2005, $10,000 for married taxpayers and $5,000 for single taxpayers. This explains in part the relatively small number of taxpayers that itemize.

State (* indicates no broad-based state income tax)	AMT Filers as Percentage of all Returns 2006	Total Property, Income or Sales Taxes per Return Filed 2006	Percentage of Filers Itemizing Deductions 2006	Average Taxes Paid Deduction 2006
Iowa	1.66%	4,263	32.18%	6,835
Indiana	1.46%	4,628	30.69%	6,783
West Virginia	1.18%	3,060	18.67%	6,710
Utah	2.04%	3,997	41.02%	6,581
Montana	1.81%	3,923	31.45%	6,557
Oklahoma	1.53%	3,230	30.45%	6,503
Florida	1.95%	5,201	33.64%	6,409
Arkansas	1.42%	4,152	25.34%	6,372
Arizona	1.97%	5,002	38.80%	6,361
North Dakota	1.16%	3,638	19.69%	5,933
Washington	1.81%	6,204	37.71%	5,735
Louisiana	1.72%	4,786	24.28%	5,700
New Mexico	1.33%	3,859	26.49%	5,570
Mississippi	1.13%	4,152	24.89%	5,287
Nevada	1.50%	4,815	37.80%	5,055
Wyoming	1.44%	6,935	23.81%	4,875
Alabama	1.18%	2,844	30.81%	4,834
Tennessee	0.99%	4,497	26.28%	4,504
South Dakota	0.96%	4,449	19.87%	4,256
Alaska	1.02%	3,342	26.82%	4,019

Source: Internal Revenue Service, Census of Governments 2004-2005, and CRS calculations.

Table 5 also presents data on the percentage of AMT filers by state and the average state and local taxes paid deduction by state in 2006. The states are ordered by the amount of potentially deductible taxes. Note that taxpayers in states that do not levy an income tax will have a greater incentive to itemize and claim the deduction for taxes paid.[18] 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. The IRS reported that in 2006, 11.2 million taxpayers took advantage of the sales tax deduction option, deducting $18.9 billion. 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.

According to the tables in IRS, the *state* sales tax deduction for a family of four in Knoxville, Tennessee, with income between $100,000 and $120,000, would have been $1,696 in 2007.[19] In addition, this family could deduct another $545 in 2007 for *local* sales taxes paid. Further, if this family had purchased a $20,000 car (or boat), they could deduct another $1,850. In sum, this Tennessee family could

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

[19] The state sales tax rate in Tennessee is 7%, and the local rate for Knoxville is an additional 2.25% for a combined sales tax rate of 9.25%.

have deducted an additional $4,091 under the sales tax deduction option. With the standard deduction for joint filers at $10,700 in 2007, 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, either income or sales, was added to the property tax to simulate a state's reliance on deductible taxes. Comparing states based on what current law would allow seems to be a reasonable proposition.

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 further action is taken on the AMT in 2008, the reversion would occur beginning with the 2008 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 and could include changing the deductions allowed against AMT liability. Thirdly, the AMT could be repealed outright.

If the AMT is repealed, federal revenue could decline considerably. Current budget forecasts predict repeal would generate an $872 billion revenue loss over the 2007-2017 budget window, assuming the EGTRRA and JGTRRA tax cuts are **not** extended.[20] 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.[21]

The second option, extension of the 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 approximately $500 billion over the 2009-2017 budget window assuming the regular income tax cuts are *not* extended beyond 2010.[22] If the tax cuts are extended, the cost of this proposal would rise significantly. 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.

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[20] U.S. Congress, Joint Committee on Taxation, "Present Law and Background Relating to the Alternative Minimum Tax," JCX-38-07, June 25, 2007.

[21] U.S. Department of Treasury, *Fact Sheet: A Tale of Two Taxes, Regular Income Tax and the AMT*, March 2, 2005.

[22] Congressional Budget Office, *Budget Options*, Feb. 2007, Revenue Option 5, p. 264.

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 would 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 would the impact of AMT adjustments.

For example, the average taxes paid itemized deduction for filers residing in New York was $17,589 in 2006 whereas in Tennessee, the average taxes paid itemized deduction was $4,504 (see **Table 5**). 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, California, Connecticut, New Jersey, District of Columbia, Massachusetts, and Maryland are the top seven) would be the most negatively affected if the AMT were to be allowed to revert to pre-2001 rules. In contrast, states with relatively low taxes paid deductions would be the least negatively affected. Note that states with the relatively small taxes paid deduction are typically states without broad-based income taxes. If the AJCA 2004 sales tax deduction option were extended beyond 2007, 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. Note that reversion to pre-2001 rules would result in a significant increase in the number of AMT filers in all states, regardless of state and local taxes.

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, would 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 13.2% ($358.6 billion) of total federal government current expenditures in 2006.[23] 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 agree that the AMT issue will need to be addressed again in 2008. 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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[23] *Economic Report of the President*, Feb. 2008, Table B-82, p. 323.