Executive Summary

Taxpayer outcry is likely to get louder as more and more taxpayers will have to deal with the extremely complex *alternative minimum tax (AMT)*. Government forecasters project that the AMT will hit 9 million taxpayers by 2007.

Calculating the AMT requires a taxpayer to compute his or her taxes twice. Line 48 of form 1040 instructs the taxpayer how to determine whether he or she may be affected by the AMT. If the AMT applies, the taxpayer must recompute taxable income. Generally, the AMT results in the loss of tax write-offs and a higher tax bill.

"Generally, the AMT results in the loss of tax write-offs and a higher tax bill."

Today the AMT affects less than one out of every 150 taxpayers. By 2007, however, government analysts project it will affect one out of 14. Many of those taxpayers will neither be "rich" nor have a lot of deductions. Why? AMT exemption and bracket amounts are fixed and not indexed for inflation. As nominal income increases, more becomes taxable under higher AMT rates. More taxpayers, particularly the non-"rich," will have to pay the higher alternative minimum tax.

As with individuals, a corporation must first figure out its taxable income and tax liability under the regular income tax. It then must modify taxable income under the AMT using a series of adjustments and preferences, requiring about a dozen or more recalculations.

Another unfortunate property of the corporate AMT is that its burden is greatest when the economy is weakest. The most revenue ever collected under the AMT came during the 1990 recession. During recession, the income growth of companies slows or declines. Tax liability likewise falls or net operating losses are used to reduce future tax liability. Because the AMT denies or reduces many deductions or credits, AMT liability is higher, triggering AMT taxes. In other words, financially-pinched companies have to pay federal income taxes at a time when they can least afford to do so.

"For every dollar the government expects to raise from increasing the corporate AMT by $1 billion, the total government sector picks up only 8 cents."

It is easy to see why the alternative minimum tax is onerous to taxpayers. But there are also consequences that carry over into the entire economy. Here's why.

- Compliance costs amounting to $1.5 billion, or at least 30 percent of current AMT revenue make the AMT a very expensive tax to collect. Even worse, compliance costs are a dead-weight loss to society.
- Government forecasts wrongly assume that increasing either the corporate or individual AMT by a dollar raises a dollar. For every dollar the government expects to raise from increasing the corporate AMT by $1 billion, the total government sector picks up only 8 cents, and the economy foregoes $2.87 in GDP.
- For every dollar the government expects to raise from increasing the individual AMT by $1 billion, the total government sector picks up 47 cents, and the economy foregoes $1.72 in GDP.

Over the next decade, a backlash could result as one out of fourteen taxpayers come under the AMT. The main reason for this expansion is because, unlike the regular income tax, the AMT is not indexed for inflation. As the Congress and White House consider tax cuts, they would well consider the options discussed in this paper to scale back or eliminate the alternative minimum tax.

Table of Contents

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COMPLICATING THE FEDERAL TAX CODE: A Look At The Alternative Minimum Tax (AMT)

Taxpayer outcry against an increasingly complex federal income tax code continues to grow. The volume is likely to get louder as more and more taxpayers will have to deal with an extremely complex provision in the tax code, the *alternative minimum tax (AMT)*. Government forecasters project that the AMT, which affected less than 370,000 taxpayers in 1994, will hit 9 million by 2007.[1]

"The AMT is supposed to make sure that all taxpayers (read wealthy) pay their 'fair share' of taxes."

The AMT is supposed to make sure that all taxpayers (read wealthy) pay their "fair share" of taxes. Complexity arises because affected individuals and corporations must figure their taxes twice, once using the normal rules of the regular tax system and then using a set of complicated AMT rules. These two sets of calculations make the AMT, at best, time-consuming and confusing. At worst, the AMT can produce inefficiencies harmful to economic growth.

This report takes a closer look at both the individual and corporate alternative minimum taxes, beginning with how they evolved. Next come descriptions of how the individual and corporate AMTs work followed by a discussion of how they affect the economy. The last section examines policy changes that could ameliorate AMT effects.

History of the Alternative Minimum Tax

The alternative minimum tax originated in 1969. A Treasury Dept. study released in January of that year reported that 155 individuals making more than $200,000 (or $875,000 in 1997 dollars) had paid no federal income taxes in 1967.[2] In response to the ensuing furor, the Congress came up with a minimum tax. What follows is a summary of AMT tax legislation since then. [See Table 1 for a brief legislative history.]

Tax Reform Act of 1969

One part of the sizable tax reform bill of 1969 established an *add-on minimum tax* for individuals and corporations. It specified a minimum tax of 10 percent on *preferences* above $30,000 plus the amount of regular taxes paid. Preference are generally income or deduction items that receive favorable treatment under the regular tax. The minimum tax was paid in addition to regular tax liability.

"At worse, the AMT can produce inefficiencies harmful to economic"

For individuals, the most important preference was excluded capital gains.[3] Besides capital gains, key corporate preferences included accelerated depreciation on buildings, bad debt deductions of financial institutions and percentage depletion.[4]

Tax Bills of 1970 and 1971

The 1970 tax bill provided some relief to the minimum tax by including a 7-year carryover if the exemption exceeded tax preferences under the minimum tax. If tax preferences were less than regular taxes plus $30,000, the difference could be carried forward to increase the exemption on future tax preferences.

The Revenue Act of 1971 increased the minimum tax by adding more items to the list of preferences.

Table 1
Brief Legislative History of the Alternative Minimum Tax

Sources: Congressional Quarterly, *Congress and the Nation*, Vols. III through VIII, Washington, DC, various years and selected tax bills.

Brief Legislative History of the Alternative Minimum Tax		
Legislation	**Individuals**	**Corporations**
Tax Reform Act of 1969	Established a 10% minimum tax on some otherwise tax-free income and income offset by certain major deductions (called tax preferences) that was an add-on to regular tax liability. Provided an exemption of $30,000 in preferences plus regular taxes paid.	Established a 10% minimum tax on some otherwise tax-free income and income offset by certain major deductions (called tax preferences) that was an add-on to regular tax liability. Provided an exemption of $30,000 in preferences plus regular taxes paid.
Tax Bill of 1970	Allowed a 7-year carryover of normal income taxes exceeding the exemption to offset future income subject to the minimum tax.	Allowed a 7-year carryover of normal income taxes exceeding the exemption to offset future income subject to the minimum tax.
Revenue Act of 1971	Expanded the list of preference items	Expanded the list of preference items
Tax Reform Act of 1976	Increased minimum tax from 10% to 15%. Reduced the exemption to the greater of $10,000 or one-half of regular tax payment. Expanded tax preferences to include itemized deductions (except medical and casualty) exceeding 60% of AGI, intangible drilling gas and oil costs exceeding deductions if costs were capitalized and accelerated depreciation on equipment leases.	Increased minimum tax from 10% to 15%. Reduced the exemption to the greater of $10,000 or the regular tax payment. Eliminated provision that allowed corporations to carryover excess regular taxes that offset tax preference items. Required timber companies to include 2/3rds of capital gains in minimum-tax base, thereby excluding them from the changes.
Revenue Act of 1978	Established a new, alternative minimum tax, payable if it exceeded the sum of a taxpayer's regular tax and his minimum tax, levied on taxable income, plus excluded capital gains and excess itemized deductions. After a $20,000 exemption, rates were graduated (10% up to $40,000; 20% on $40,000 to $80,000; 25% thereafter). Removed capital gains from preference items that reduced, dollar-for-dollar, personal service income subject to the 50% maximum rate on "earned income."	
Economic Recovery Tax Act of 1981	The 25% reduction in *all* individual income tax rates also applied to the alternative minimum rate, thereby lowering the rate from 25% to 20%. Other changes in ERTA, such as depreciation and the maximum tax on earnings, altered tax preferences.	Changes in depreciation lives altered the amount of tax preference.
Tax Equity and Fiscal Responsibility Act of 1982	Eliminated the add-on minimum tax and established a more comprehensive, alternative minimum tax. Taxpayers were to pay 20% of taxable income plus tax preference items above $30,000 for single returns and $40,000 for joint returns.	Retained add-on minimum tax but scaled back several 1981 incentives, particularly depreciation. Directly reduced the value of selected preferences, such as percentage depletion for coal and iron ore, bad debt reduction, financial institution deductions for tax-exempt interest, amortization of pollution control facilities, intangible drilling costs and mineral exploration and development costs by 15%.
Tax Reform Act of 1986	Raised the rate from 20% to 21% and phased out the exemption, starting at $112,500 for single returns and $150,000 for joint returns. Added tax preference items such as interest on tax-exempt, industrial development bonds, certain tax shelters and appreciated value of property donated to charities. Eliminated some tax preferences such as tax-exempt income earned by Americans working abroad. [See Table 3 for a list of preference items and Table 4 for a sample calculation of the AMT.]	Established a corporate alternative minimum tax with a 20% rate and a broader income definition. Changed the exempt amount to $40,000 with a phase-out starting at $150,000. The minimum tax base also included 1/2 the excess of "book income" over the minimum tax base. After 1989, book income was to be converted to "adjusted current earnings" (ACE) which depends on earnings and profits. 75% of the difference between ACE and taxable AMT was to be included in the minimum tax base.
Revenue Reconciliation Act of 1993	Created a two-tier, AMT schedule of 26% for AMT income less the exemption up to $175,000 and 28% thereafter. Raised the exemption from $30,000 to $33,750 for single returns and from $40,000 to $45,000 for joint returns.	Eliminated the difference in depreciation rules between ACE and the regular AMT base.
Taxpayer Relief Act of 1997		Repealed the AMT for corporations with gross receipts under $5 million. Depreciation recovery periods under AMT conform to those under regular tax law.

Tax Reform Act of 1976

The Tax Reform Act of 1976 increased the minimum tax for both individuals and corporations. It raised the tax rate from 10 to 15 percent and reduced the exemption to the greater of $10,000 or one-half of the regular tax payment. Individuals faced more tax preference items, including itemized deductions (except medical and casualty) exceeding 60% of adjusted gross income (AGI), intangible drilling gas and oil costs exceeding deductions if costs were capitalized and accelerated depreciation on equipment leases.

Corporations lost the provision that allowed them to carryover excess regular taxes that offset tax preference items. Timber companies were required to include two-thirds of capital gains in the minimum-tax base, thereby excluding them from the changes.

Revenue Act of 1978

The 1978 tax bill established a new, alternative minimum tax for individuals. The new AMT was payable if it exceeded the sum of a taxpayer's regular tax and his or her minimum tax, levied on taxable income, plus excluded capital gains and excess itemized deductions. A graduated schedule replaced the flat 15 percent rate. Also removed were capital gains from preference items that reduced, dollar-for-dollar, personal service income subject to the 50% maximum rate on "earned income."[5]

"Because the Reagan tax cut applied to all individual income tax rates, the alternative minimum rate was lowered from 25% to 20%."

Economic Recovery Tax Act of 1981 (ERTA)

Because the Reagan tax cut applied to *all* individual income tax rates, the alternative minimum rate was lowered from 25% to 20%. Other changes in ERTA, such as those affecting depreciation lives and the maximum tax on earnings, altered tax preferences for both individuals and corporations, generally lowering AMT liability.

Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA)

TEFRA eliminated the add-on minimum tax for individuals and established a more comprehensive, alternative minimum tax. Returning to a flat rate, taxpayers were to pay 20% of taxable income plus tax preference items above $30,000 for single returns and $40,000 for joint returns.

TEFRA also increased corporate minimum taxes by scaling back several incentives enacted in 1981, particularly those affecting depreciation. Congress also adopted a new way to reduce the value of selected preferences, such as percentage depletion for coal and iron ore, bad debt reduction, financial institution deductions for tax-exempt interest, amortization of pollution control facilities, intangible drilling costs and mineral exploration and development costs. Directly reducing these preferences by 15 percent circumvented the need to compare them to the corporation's total taxable income. In 1984, the cutback was further increased to 20 percent.[6]

Tax Reform Act of 1986

Just as the 1969 Treasury study provoked an outcry against some higher income individuals paying little or no tax, a 1984 Citizens for Tax Justice report did the same for corporations. Congress responded to the inflammatory analogy that some Fortune 500 companies "pay less in taxes than the people who wax their floors or type their letters" by enacting a more punitive AMT for corporations.[7]

Doing away with the add-on minimum tax, the tax reform bill established a corporate AMT with a 20% rate, a broader income definition and an exempt

Table 2
Individual Taxpayers and the Alternative Minimum Tax, Selected Years

Calculations based on return data from Internal Revenue Service, *Statistics of Income Bulletin*, Summer 1997, Washington, DC, Table 1.

Individual Taxpayers and the Alternative Minimum Tax, Selected Years						
Year	**1980**	**1985**	**1990**	**1992**	**1993**	**1994**
All Returns (thous)	**93,902**	**101,660**	**113,717**	**113,605**	**114,602**	**115,943**
Annual % change		1.6%	2.3%	0.0%	0.9%	1.2%
Returns Paying Tax (thous)	**73,906**	**82,762**	**89,844**	**86,708**	**86,420**	**87,602**
As % total returns	78.7%	81.4%	79.0%	76.3%	75.4%	75.6%
AMT returns (thous)	**123**	**428**	**132**	**287**	**335**	**369**
Annual % change		28.4%	-20.9%	47.4%	16.5%	10.3%
As % total returns	0.1%	0.4%	0.1%	0.3%	0.3%	0.3%
As % returns paying tax	0.2%	0.5%	0.1%	0.3%	0.4%	0.4%
Total Individual Taxes ($mil)	**250,341**	**325,701**	**447,127**	**476,239**	**502,788**	**534,856**
Total AMT Tax Paid ($mil)	**850**	**3,792**	**1,617**	**2,059**	**2,300**	**2,786**
Annual % change		34.8%	-15.7%	12.8%	11.7%	21.1%
As % total income taxes	0.3%	1.2%	0.4%	0.4%	0.5%	0.5%

amount of $40,000 with a phase-out starting at $150,000. In response to concerns that a corporation might report profits for financial purposes but pay no income taxes, the Senate added a *book income* adjustment. The final bill adopted this approach for 1987 to 1989 and replaced it with *adjusted current earnings (ACE)* thereafter because of concerns that AMT companies might adjust their financial statements.[8]

Between 1987 and 1989, if book income was greater than the minimum tax base, the adjustment included one-half of the excess in a corporation's minimum tax base. Since 1990, the ACE adjustment does not depend on how the company reports income for financial purposes but depends instead on earnings and profits, thereby accounting for the portion of dividends paid out in income instead of as a distribution of capital. Specifically, 75 percent of the difference between a corporation's ACE and its taxable income for AMT purposes is included in the alternative minimum tax base. Unlike the regular AMT base, which only included differential depreciation for assets acquired after 1986, the ACE base includes all depreciation.

For individuals, tax reform raised the AMT rate from 20% to 21% and phased out the exemption, starting at $112,500 for single returns and $150,000 for joint returns. It also added tax preference items such as interest on tax-exempt, industrial development bonds, certain tax shelters and appreciated value of property donated to charities and eliminated some tax preferences such as tax-exempt income earned by Americans working abroad. [See Table 3 for a list of preference items.]

Revenue Reconciliation Act of 1993

The tax bill of 1993 reinstated two rates for the individual AMT and increased the exemption from $30,000 to $33,750 for single returns and from $40,000 to $45,000 for joint returns. Tax rates were set at 26% for AMT income less the exemption of $175,000 and under and at 28% for higher amounts.

On the corporate side, the big change was to eliminate the difference in depreciation rules between ACE and the regular AMT base, removing a source of considerable complexity.

Taxpayer Relief Act of 1997

Following the trend from 1993, the 1997 tax bill further simplified the corporate AMT. For physical assets put in place after 1998, the recovery periods (but not the methods) for the AMT depreciation adjustment would be the same as those under the regular income tax. The AMT was eliminated for small corporations (gross receipts under $5 million).

How the AMT Affects Individuals Today

Today the alternative minimum tax neither affects many taxpayers nor accounts for much revenue. In 1994, only 368,964 out of 115.9 million individual returns, or 0.3 percent of taxpayers, had AMT liability. The $2.8 billion in AMT taxes amounted to only one-half percent of the $534.8 billion of federal individual income taxes. [See Table 2 for the number and amount of taxpayers affected by the AMT for selected years since 1980.]

Although small, the influence of the AMT has grown over time. For example, in 1980, the AMT affected only 0.1 percent of returns and accounted for 0.3 percent of income taxes. And, as discussed in a later section, the effect of the AMT will continue to expand over the next decade. To understand why, we now turn to how the AMT for individuals is calculated.

Calculating the AMT for Individuals

Calculating the AMT requires a taxpayer to compute his or her taxes twice. The first time, the taxpayer follows the normal rules, using allowable deductions to reduce taxable income and allowable credits to reduce the amount of tax owed. Line 48 of the form 1040 instructs the taxpayer on how to determine whether he or she may be affected by the AMT. If the AMT applies, the taxpayer must recompute taxable income using a series of *adjustments and preferences*.

"Today the alternative minimum tax neither affects many taxpayers nor accounts for much revenue."

Adjustments and Preferences

Most adjustments and preferences increase taxable income by making the taxpayer add back many of the deductions or credits available under the regular income tax.[9] Included are many popular deductions such as the standard deduction, personal exemptions, state and local taxes, charitable donations, depreciation and passive losses. The AMT also has a different set of rules for deducting net operating losses, although the AMT form calls it a *reconciliation* instead of a preference.

Adjustments and preferences increased the taxable income of taxpayers subject to the AMT by $19 billion in 1994. Reconciliation items added another $6.3 billion. Five items account for almost all of this increase: state and local taxes (39.7%); regular tax net operating losses (28.8%); miscellaneous deductions above the 2% floor (16.0%); personal exemptions (9.5%) and post-1986 depreciation (7.9%).[10] [See Table 3 for items relating to the AMT for individuals in 1994.]

AMT Income, Exemptions, Tax Rate and Credits

AMT income is regular taxable income (from form 1040) plus personal exemptions and the AMT preference items. In 1994, taxable income of affected taxpayers rose by over a third, from $71.9 billion (form 1040) to $97.2 billion (AMT income).

After computing AMT income the taxpayer subtracts the appropriate AMT exemption, which adds more complexity. Instead of a flat amount, the exemption depends on income. Starting at $45,000 for joint returns and $33,750 for single returns, it phases out at a rate of 25 cents for every dollar

Table 3
AMT Taxable Income and Preference Items, 1994

[1] From Robert P. Harvey & Jerry Tempalski, "The Individual AMT: Why It Matters," *National Tax Journal*, Vol. L, No. 3, September, 1997, Table 1.

[2] Each adjustment and preference is divided by total adjustments and preferences.

* Less than 500.

** Less than $500,000.

[d] Indicates a deferral preference.

"Calculating the AMT requires a taxpayer to compute his or her taxes twice."

AMT Taxable Income and Preference Items, 1994				
	Amount[1] ($mil.)	Returns[1] (thous.)	Average Amount	Adjustments, Preferences & Reconciliation Items as % of Total[2]
Taxable Income from 1040	**71,929**	**464**	**$155,019**	
Adjustments and Preferences (Form 6251)	**19,000**	**463**	**$41,037**	**75.1%**
State & local taxes	10,039	402	$24,973	39.7%
Miscellaneous deductions above 2% floor	4,050	213	$19,014	16.0%
Post-1986 depreciation[d]	2,011	125	$16,088	7.9%
Passive activity loss[d]	1,269	129	$9,837	5.0%
Incentive stock options[d]	928	7	$132,571	3.7%
Long-term contracts[d]	446	6	$74,333	1.8%
Charitable donations	231	15	$15,400	0.9%
Estate beneficiaries[d]	228	24	$9,500	0.9%
Standard deduction	216	58	$3,724	0.9%
Private activity bonds interest	186	31	$6,000	0.7%
Depletion	140	10	$14,000	0.6%
Loss limitations[d]	123	5	$24,600	0.5%
Medical deductions	83	37	$2,243	0.3%
Certain home mortgage interest	68	8	$8,500	0.3%
Circulation expenses[d]	44			0.2%
Intangible drilling costs[d]	41	3	$13,667	0.2%
Pre-1987 accelerated depreciation[d]	30	7	$4,286	0.1%
Related adjustments[d]	12	5	$2,400	0.0%
Tax shelter farm loss[d]	4	1	$4,000	0.0%
Mining costs[d]	1	*		
Patron's adjustment[d]	1	*		
Pollution control facilities[d]	**	*		
Installment sales[d]	-2	*		0.0%
R&E expenditures[d]	-4	*		0.0%
Investment interest	-6	6	-$1,000	0.0%
Adjusted gain or loss[d]	-483	41	-$11,780	-1.9%
State & local tax refunds	-656	195	-$3,364	-2.6%
Other Reconciliation Items	**6,316**			**24.9%**
Regular tax net operating losses	7,303	13	$561,769	28.8%
Personal exemptions	2,394	276	$8,674	9.5%
Limitation on itemized deductions	-1,703	252	-$6,758	-6.7%
AMT net operating losses	-1,860	5	-$372,000	-7.3%
Undetermined	182			0.7%
TOTAL	**25,316**	**464**	**$54,560**	
AMT Income	**97,245**	**464**	**$209,580**	
As % of Taxable Income	**135.2%**		**135.2%**	

of AMT income above $150,000 for joint returns and $112,500 for single returns. There is no exemption for joint incomes above $330,000 and single incomes above $247,500. Finally, unlike personal exemptions under the regular income tax, AMT exemptions are not indexed for inflation, meaning that more and more taxpayers will become subject to the AMT over time.

"AMT exemptions are not indexed for inflation, meaning that more andmore taxpayers will become subject to the AMT over time."

There are two brackets to the AMT. For AMT income less the AMT exemption up to $175,000, the *statutory* tax rate is 26% and 28% thereafter. However, the *effective* AMT rates are 32.5% and 35% for taxpayers caught in the exemption phaseout range. After the phaseout, the effective tax rate returns to the 28% statutory rate. [See Table 4 for statutory and effective tax rates for joint returns). As with the exempt amounts, the AMT brackets are not indexed, forcing more and more taxpayers into the AMT over time.

Statutory and Effective AMT Tax Rates for Joint Returns

AMT Income[1]	Statutory AMT Rate	Effective Tax Rate
Below $45,000	0	0
$45,000 to $150,000	26%	26.0%
$150,001 to $205,999	26%	32.5%
$206,000 to $329,999	28%	35.0%
$330,000 and over	28%	28.0%

Table 4
Statutory and Effective AMT Tax Rates for Joint Returns

[1] Form 1040 taxable income plus personal exemptions adjusted for preference items. Does not include the AMT exemption.

Generally, the AMT results in the loss of tax credits, which amounted to $1.3 billion in 1994. The only major tax credit that can be used to reduce the AMT is the foreign tax credit.[11]

But some taxpayers with AMT liability may be able to use some of that to offset future taxes under the regular system. Specifically, deferral preferences, such as those relating to depreciation, can offset future tax liability. Because deferrals make up less than one-fifth of preferences, potential future credits are small compared to AMT tax liability.[12] [See Table 3 which designates deferral preferences.]

"…in 1994, 20 percent of taxpayers who filed AMT returns did not have any AMT liability."

More Complications

The AMT can complicate tax return filing in other ways, even for taxpayers who do not owe AMT tax. For example, in 1994, 20 percent of taxpayers who filed AMT returns did not have any AMT liability.[13]

More difficulty arises because many AMT preferences, such as depreciation and amortization, have different rules, forcing taxpayers to keep two sets of records. And, taxpayers with AMT or regular tax credits find themselves filing out added, complex forms.

A Sample AMT Calculation

To show how the AMT works in practice, let us look at an example based on the 1994 data shown in Table 3. The steps, shown in Table 5, compute taxpayer liability under the regular income tax and the AMT using averages per return for the major categories of AMT items. But remember that these computations oversimplify because they do not show the hard work a taxpayer would most likely endure in figuring: (1) whether he or she was subject to the AMT and (2) the value of the preferences and adjustments which often have different rules under the regular tax system versus the AMT.

With that caveat, let us review the major AMT steps for the average, 1994 AMT return. Adding back personal exemptions ($8,674) and preference

Table 5
Calculating the Individual AMT Using Average 1994 AMT Return Data

[1] Applicable tax rate of 28%. See Table 4.

[2] Using appropriate 1994 schedules.

Calculating the Individual AMT Using Average 1994 AMT Return Data	
Taxable Income	**$155,019**
Plus	
Personal exemptions	$8,674
Preference items	$45,886
Equals	
AMT Income	**$209,580**
AMT Exemption	
Single ($33,750 with 25% phaseout starting at $112,500)	$9,480
Joint ($45,000 with 25% phaseout starting at $150,000)	$30,105
AMT Income less Exemption	
Single	$200,100
Joint	$179,475
AMT Tax[1]	
Single	$52,528
Joint	$46,753
Regular Tax[2]	
Single	$45,446
Joint	$41,111
Additional Tax due to AMT (in dollars)	
Single	$7,081
Joint	$5,641
Additional Tax due to AMT (in percent)	
Single	15.6%
Joint	13.7%

items ($45,886) increases AMT income ($209,580) by 35 percent over taxable income from the regular income tax ($155,019). Because AMT income is in the phaseout range, the AMT exemption reduces to $9,480 for single returns and $30,105 for joint returns.

The amount of AMT income subject to tax (AMT income less the AMT exemption) is $200,100 for single returns and $179,145 for joint returns. At the 28% tax rate, AMT tax liability for taxpayers filing single returns would be $52,528 and $46,753 for taxpayers filing joint returns. Under the regular income tax, single returns would owe $45,446 and joint returns would owe $41,111. In other words, the AMT would have increased the tax liability of the average single filer in 1994 by $7,081 or 15.6 percent. Joint filers would have owed $5,641, or 13.7 percent, more in tax.

"The biggest increase in AMT filers over the next ten years will be taxpayers with between $50,000 and $100,000 in adjusted gross income."

Why the AMT Will Hit More Taxpayers over Time

Today the AMT affects less than one out of every 150 taxpayers. By 2007, however, government analysts project it will affect one out of 14. Many of those taxpayers will not come from the ranks of those the AMT was designed to reach. That is, they will neither be "rich" nor have lots of deductions.

According to projections from the Joint Committee on Taxation Individual Tax Model, the biggest increase in AMT filers over the next ten years will be taxpayers with between $50,000 and $100,000 in adjusted gross income.[14] While these taxpayers accounted for 26 percent of AMT returns in 1997, they will make up 40 percent in 2007. AMT filers with between $100,000 and $200,000 in AGI also will increase from 35 percent to 40 percent. Taxpayers with less than $50,000 or more than $200,000 will decline from 32 percent of AMT returns to 17 percent. [See Figure 1 for AMT filers by income in 1997 and 2007.]

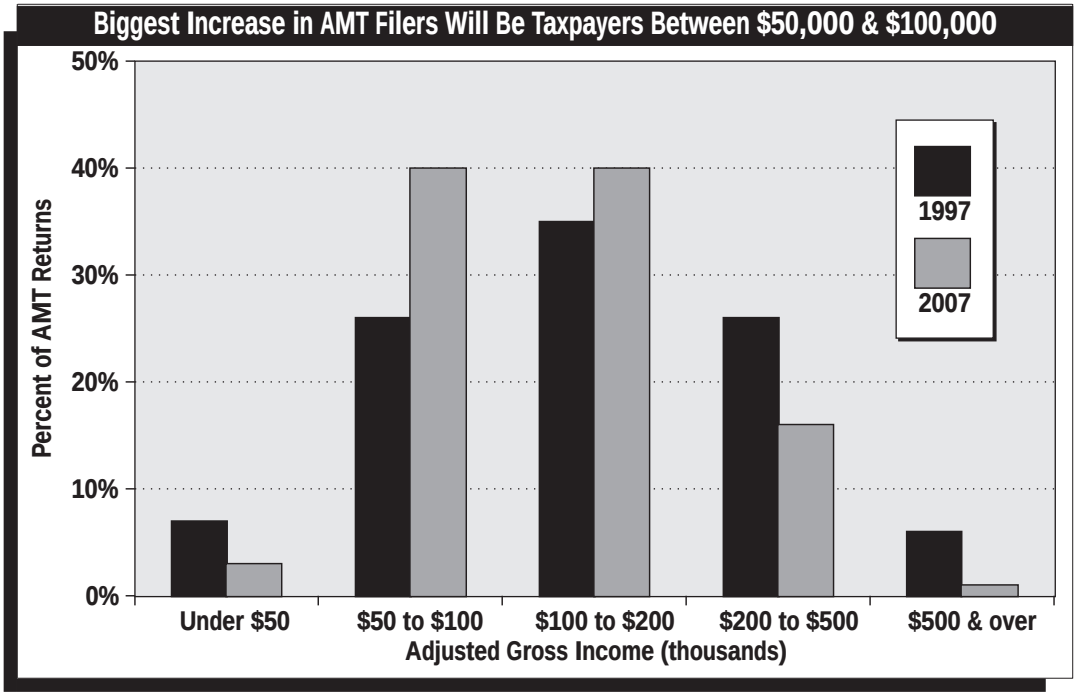


Figure 1
Biggest Increase in AMT Filers Will Be Taxpayers Between $50,000 & $100,000

Sources: Harvey & Tempalski; JCT Individual Income Tax Model

Likewise taxpayers with incomes between $50,000 and $200,000 will pay a larger share of AMT taxes than they do today, an increase from 28 percent to 50 percent. The share of AMT taxes paid by those with over $500,000 in income will decline from 38 percent today to 16 percent in 2007. [See Figure 2 for AMT tax liability by income in 1997 and 2007.]

Why will the burden of the AMT increasingly shift away from the "rich" to those of more modest means? As discussed earlier, unlike the regular income tax, key AMT tax parameters are not indexed for inflation, causing more and more taxpayers to fall under the AMT for several reasons.

Under the regular income tax, as *nominal* income increases with inflation so do personal exemptions, standard deductions and bracket amounts. Because tax is levied on income less exemptions and deductions, inflation-indexing slows the increase in *taxable* income. Indexing of the brackets helps prevent taxpayers from being taxed at higher marginal rates.[15]

"Key AMT tax parameters are not indexed for inflation, causing more and more taxpayers to fall under the AMT"

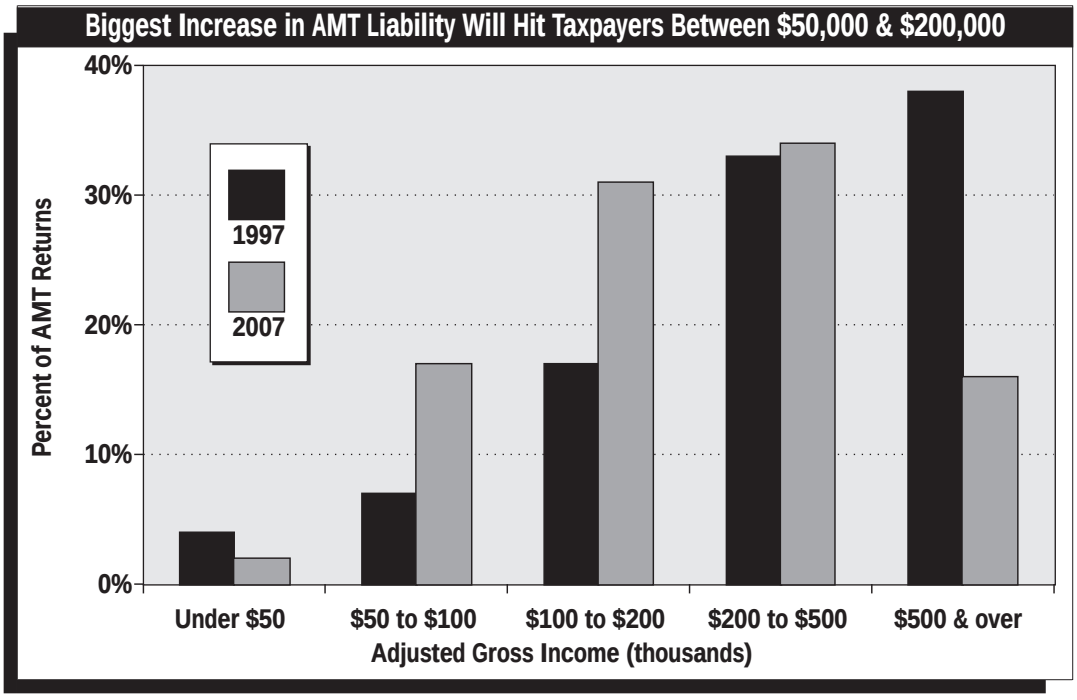


Figure 2
Biggest Increase in AMT Liability Will Hit Taxpayers Between $50,000 & $200,000

Sources: Harvey & Tempalski; JCT Individual Income Tax Model

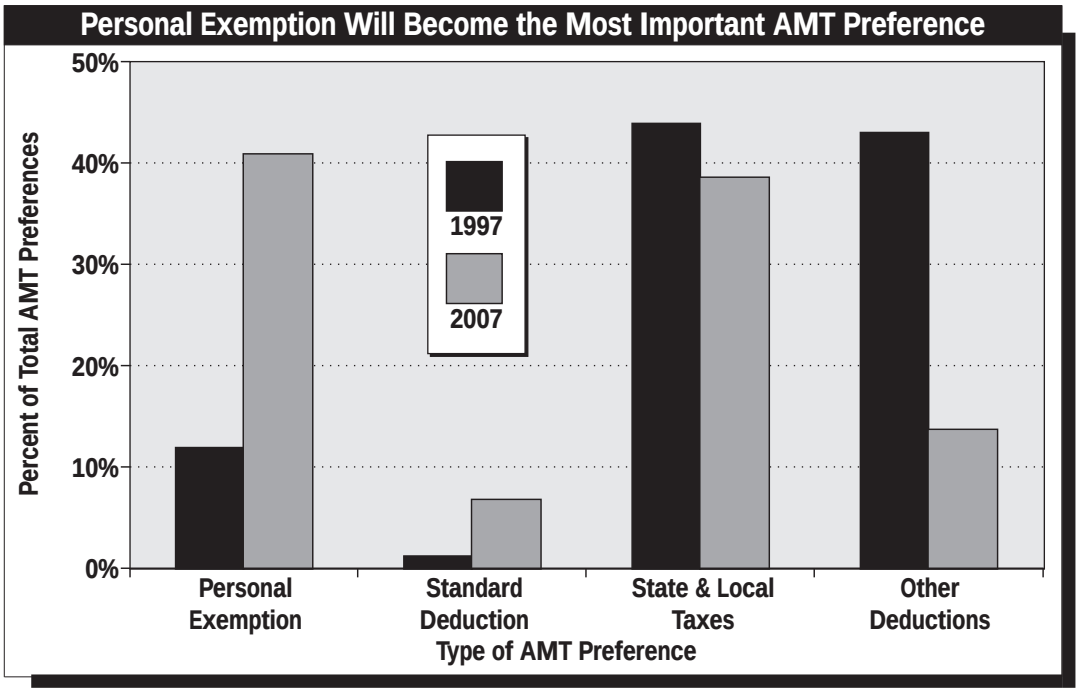
Slower increases in taxable income and bracket creep help hold down the increase in regular tax liability.

In contrast, the AMT exempt and bracket amounts are fixed. As nominal income increases, more of it becomes taxable under the AMT, and more of taxable AMT income is taxed at the higher 28% rate. As the gap between tax liability under the regular indexed income tax and the unindexed AMT widens, more taxpayers, particularly the non-"rich," will have to pay the higher alternative minimum tax.

Lack of AMT indexing also will change the importance of preference items. Today state and local taxes are the largest AMT preference. By 2007, however, the personal exemption will eclipse them, rising from 12 percent of total preferences to 41 percent. The standard deduction also will gain ground, increasing from 1 percent today to 7 percent by 2007. [See Figure 3 for the distribution of AMT preferences in 1997 and 2007.]

Figure 3
Personal Exemption Will Become the Most Important AMT Preference

Sources: Harvey & Tempalski; JCT Individual Income Tax Model



How the Corporate AMT Works

The AMT for corporations works much the same as the individual AMT. That is, it reduces the amount of deductions and credits that a corporation can use in computing its AMT tax base, thereby increasing the amount of tax owed.

Calculating the Corporate AMT

As with individuals, a corporation must first figure out its taxable income and tax liability under the regular income tax. It then must modify taxable income under the AMT using a series of adjustments and preferences. Again these modifications are complex and time-consuming, requiring about a dozen or more recalculations. [See Table 6 for the relative importance of corporate adjustments and preferences.]

Once adjustments and preferences have been added back to taxable income, a corporation may subtract losses from earlier years. Under the regular income tax, companies may use prior losses to reduce current taxable income. If they exceed current income, the company may carry these losses forward to reduce taxable income in future years.[16] AMT treatment is less generous, limiting the reduction from losses to no more than 90 percent of AMT income.[17]

Importance of Corporate AMT Adjustments and Preferences	
Adjustment or Preference	**As % of Total Adjustments & Preferences**
Adjustment	
Depreciation	53.0%
Adjusted current earnings	46.8%
Blue Cross/Blue Shield	5.3%
Long-term contracts	1.1%
Mining exploration and development	0.3%
Merchant marine	0.1%
Basis	-8.8%
Preference	
Percentage depletion	3.1%
Tax-exempt interest	0.9%
Intangible drilling costs	0.2%
Accelerated depreciation of real property	0.1%

Table 6
Importance of Corporate AMT Adjustments and Preferences

Source: Andrew B. Lyon, *Cracking the Code*, Brookings Institution, 1997, Table 2-4.

"Between 1980 and 1995, while corporations filing federal tax returns almost doubled, corporate AMT filers almost tripled."

Once losses are taken out, what is left is *alternative minimum taxable income*. From that is subtracted the $40,000 corporation exemption which phases out between $150,000 and $310,000. Multiplying the remainder by the 20% AMT tax rate yields tentative minimum tax before credits. Subtracting foreign tax credits leaves *tentative minimum tax*.[18]

The tax is tentative because the computations do not end here. Next, the company compares its tentative minimum tax to its regular tax liability before foreign tax credits. If the minimum tax is greater, the corporation pays its regular tax plus the difference between the minimum and regular tax. If the corporation's regular tax is bigger, the firm may reduce its regular tax by allowable business credits, such as that for research and development, provided that tax owed is not less than the tentative minimum tax.

Who Pays the Corporate AMT

Although the AMT affects relatively few firms, its influence has been growing over time. Between 1980 and 1995, while corporations filing federal tax returns almost doubled (from 2.7 million to 4.5 million), corporate AMT filers almost tripled (from 2,711 to 25,810). Most of this increase came from companies with less than $250 million in assets.[19] [See Table 7 for data on the corporate regular and alternative minimum tax, 1980 to 1995.]

"Manufacturing companies paid the most in AMT taxes"

Revenue raised from the corporate AMT tends to be small. For example, in 1994, of the $165.4 billion paid in corporate taxes, less than one percent ($1.1 billion) came from the AMT. However, as discussed in the next section, annual revenues vary a good bit because the AMT moves opposite to the business cycle.

As for industrial sectors, manufacturing companies paid the most in AMT taxes (40%). They are followed by corporations engaged in finance, insurance and real estate (23%) and transportation and public utilities (20%).[20]

Table 7
Corporate Regular and Alternative Minimum Tax, 1980-1995

Source: Internal Revenue Service, *Statistics of Income Bulletin*, Fall 1997, Washington, DC, Table 13.

Corporate Regular and Alternative Minimum Tax, 1980-1995						
	1980	**1985**	**1990**	**1993**	**1994**	**1995**
Regular Income Tax						
Returns (thous)	2,711	3,277	3,717	3,965	4,342	4,513
Tax after credits ($mil)	62,949	63,348	96,406	119,938	165,437	154,700
Minimum and alternative minimum tax						
Returns	9,213	7,797	32,458	29,325	29,462	25,810
Tax before credits ($mil)	438.8	725.9	8,104.3	4,863.1	4,459.3	4,298.3
Net AMT ($mil)	438.8	725.9	7,437.2	1,760.5	1,119.6	-444.6
AMT as % regular tax	0.7%	1.1%	7.7%	1.5%	0.7%	-0.3%

Why the AMT Is Counter-cyclical

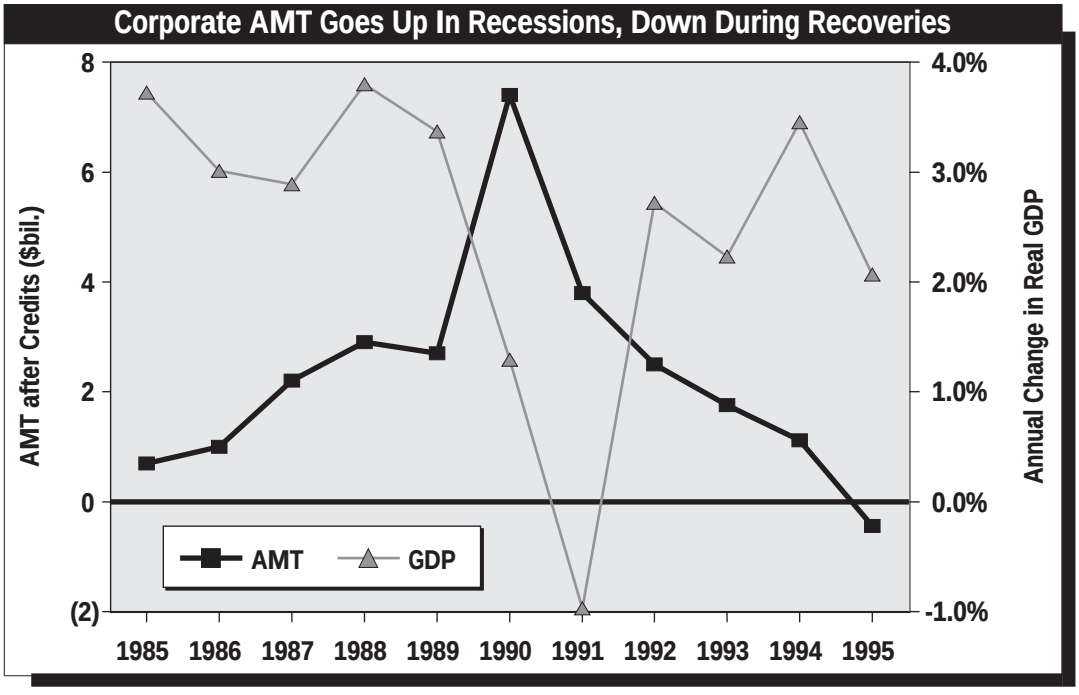
"The AMT's burden is greatest when the economy is weakest and least when the economy is booming."

Besides adding complexity to the tax code, another unfortunate property of the AMT is that it runs counter to the business cycle. That is, its burden is greatest when the economy is weakest and least when the economy is booming. The most revenue ever collected under the AMT came during the 1990 recession. As expected, total corporate income taxes declined, but AMT revenues jumped from $2.7 billion in 1989 to $7.4 billion in 1990. And the AMT's share of corporate income taxes increased from 1.1 percent to 7.7 percent. [See Table 7 and Figure 4 for the counter-cyclical nature of the AMT.]

What causes this undesirable effect? During recession, the income growth of companies slows and may even decline. After deductions and credits, the corporation's taxable income is often less than the previous year's or may even go negative. Under the regular income tax, tax liability likewise falls or the company posts a net operating loss that can be used to reduce future tax liability. Because the AMT denies or reduces many of these deductions or credits, corporate AMT liability will be higher than that under the regular

Figure 4
Corporate AMT Goes Up In Recessions, Down During Recoveries

Sources: Internal Revenue Service; Commerce Department



income tax, triggering AMT taxes. In other words, financially-pinched companies have to pay federal income taxes at a time when they can least afford to do so.

The reverse happens during economic recoveries. As growth picks up, so does the firm's income and regular tax liability, reducing either the chance that the AMT will come into play or the extra amount of AMT taxes owed. Total AMT liability can even be negative, as occurred in 1995, because credits for prior AMT payments can exceed current AMT liability.

"Because of its complexity, the AMT imposes significant compliance costs."

The Recent Tax Bill Reduced the Depreciation Problem

Depreciation, which accounts for over half of corporate adjustments and preferences, defines the rate at which companies can deduct expenses for purchases of plant and equipment from income for tax purposes. Because the AMT method was even less generous than that of the regular income tax, companies could find themselves owing more tax simply because they undertook capital investments.[21]

However, the tax bill passed last year has taken a good deal of the sting out of the corporate AMT. One of its provisions specified that depreciation recovery periods under the AMT conform to those under regular tax law. The Joint Committee on Taxation estimates that doing so will reduce AMT taxes by $18.3 billion between 1999 and 2007.[22]

How the Individual and Corporate AMTs Affect the Economy

It is easy to see why the alternative minimum tax is onerous to taxpayers. But AMT burdens do not stop with the extra taxes that individuals and businesses must pay. Rather, there are consequences that carry over into the entire economy. Here's why.

Compliance Costs

Because of its complexity, the AMT imposes significant compliance costs. A Tax Foundation survey found that the average corporation spends about 52 hours preparing AMT information. With almost 340,000 corporate filings, total paperwork demands amount to 17.6 million hours a year.[23] Valuing that time at a conservative $50 an hour means companies spend some $900 million a year complying with the AMT.

Individual taxpayers also incur expenses filing AMT returns. If they spend half the time as a business, their compliance costs would come to $600 million.[24] That means AMT paperwork and record-keeping cost individuals and businesses at least $1.5 billion each year. True compliance costs are even higher because these estimates omit taxpayers who do not file AMT returns but go through many of the calculations because they are so near filing thresholds. Also not included are costs the Internal Revenue Service incurs to police and collect the AMT.

"AMT paperwork and record-keeping cost individuals and businesses at least $1.5 billion each year."

Compliance costs amounting to at least 30 percent of current AMT revenue make the AMT a very expensive tax to collect.[25] Even worse, filling out AMT returns adds nothing to the production of goods and services. The compliance costs are a dead-weight loss to society.

Economic Effects

Although considerable, AMT compliance costs are only part of the picture. More serious is the damage to economic incentives. Specifically, the AMT reduces the return to work, save and invest by exacting a higher tax on the next dollar of income earned, that is, by raising *marginal* tax rates. Particularly hard hit are activities involving capital because many of the deductions

Table 8
Economic and Budgetary Effects of Increasing the Corporate Alternative Minimum Tax by $1 billion

Estimates from Fiscal Associates Model.

[1] For GDP and personal income, the cumulative loss between 1998 and 2010 was divided by $13 billion ($1 billion in higher AMT for 13 years). Because capital is stock that accumulates, the loss of capital in 2010 was divided by $13 billion.

[2] Revenues are dynamic, that is, they include economic effects.

[3] Cumulative dynamic revenue gain between 1998 and 2010 divided by $13 billion in static revenue gain.

"Compliance costs amounting to at least 30 percent of current AMT revenue make the AMT a very expensive tax to collect."

Economic and Budgetary Effects of Increasing the Corporate Alternative Minimum Tax by $1 billion
(Measured as a Change from Baseline)

Effects on U.S. Economy

Year	GDP ($bil)	Personal Income ($bil)	Stock of Capital ($bil)	Employment (thous)
1998	-1.37	-1.87	-3.91	-1.0
1999	-1.70	-2.03	-6.22	-2.6
2000	-2.02	-2.12	-8.07	-4.7
2001	-2.34	-2.23	-9.88	-6.3
2002	-2.61	-2.30	-11.64	-7.2
2003	-2.84	-2.34	-13.19	-7.7
2004	-3.06	-2.37	-14.54	-8.2
2005	-3.24	-2.39	-15.72	-8.6
2006	-3.40	-2.40	-16.65	-8.9
2007	-3.53	-2.40	-17.25	-9.1
2008	-3.63	-2.38	-17.59	-9.2
2009	-3.73	-2.39	-17.90	-9.2
2010	-3.82	-2.38	-18.14	-9.1
1998-2010	-37.28	-29.60	-18.14	
Per $ of AMT[1]	**-$2.87**	**-$2.28**	**-$1.40**	

Effects on Government Budgets[2] (in $billions)

Year	Receipts			Surplus (+) or Deficit (-)		
	Federal	State & Local	Total	Federal	State & Local	Total
1998	0.67	-0.16	0.51	0.68	-0.16	0.51
1999	0.62	-0.20	0.42	0.66	-0.22	0.44
2000	0.56	-0.24	0.31	0.63	-0.28	0.34
2001	0.52	-0.28	0.23	0.62	-0.35	0.27
2002	0.47	-0.32	0.16	0.61	-0.41	0.20
2003	0.43	-0.35	0.08	0.60	-0.48	0.12
2004	0.39	-0.38	0.01	0.59	-0.55	0.04
2005	0.37	-0.41	-0.04	0.59	-0.62	-0.03
2006	0.34	-0.43	-0.09	0.60	-0.70	-0.10
2007	0.33	-0.44	-0.12	0.61	-0.77	-0.16
2008	0.31	-0.45	-0.14	0.63	-0.85	-0.22
2009	0.30	-0.46	-0.16	0.65	-0.95	-0.30
2010	0.29	-0.47	-0.18	0.67	-1.05	-0.38
1998-2010	5.61	-4.60	1.00			
Per $ of AMT[3]	**$0.43**	**-$0.35**	**$0.08**			

and credits denied or altered under the AMT, such as depreciation, tax-exempt interest and other capital-operating adjustments, derive from saving and investment.

To estimate the economic effects of the AMT, we looked at what would happen if annual AMT taxes were raised by $1 billion. Higher corporate taxes come out of the return to corporate capital. A $1 billion AMT increase would raise the effective, marginal federal tax rate on corporate income by 0.5 percent.[26] Although smaller, the percentage increase in marginal tax rates for individuals would affect both capital and labor income.[27]

"The AMT reduces the return to work, save and invest by raising marginal tax rates. Particularly hard hit are activities involving capital"

Increasing the Corporate AMT by $1 billion

Based on our general equilibrium model of the U.S. economy, by 2010, a $1 billion a year increase in alternative minimum taxes on corporations would:[28]

- Reduce annual gross domestic product by $3.8 billion. Cumulative GDP loss from 1998 through 2010 would amount to $37.3 billion, nearly three times the $13 billion, static revenue gain.
- Lower annual personal income by $2.4 billion. Cumulatively, personal income would be lower by $29.6 billion.
- Reduce capital formation by $18.1 billion.
- Prevent the creation of 9,100 jobs.

[See Table 8 for the economic and budgetary effects of a $1 billion increase in the corporate AMT.]

Expressing economic effects in another way, for every dollar of *static* AMT revenue raised:

- The economy would give up $1.40 in physical assets, such as plant, machinery or equipment, that would otherwise have been sited in the United States.
- The economy would forego $2.87 in GDP.
- Of that, $2.40 are goods and services that the private business sector would have otherwise produced. Most of that output—$1.83—would have gone to compensate workers for the labor used in production.[29] The remaining 56 cents would have gone to capital compensation in the form of depreciation and a return to investors. (Both labor and capital compensation are before tax.)

"For every dollar of static AMT revenue raised, the economy would forego $2.87 in GDP."

Increasing the Individual AMT by $1 billion

By 2010, a $1 billion a year increase in alternative minimum taxes on individuals would:

- Reduce annual gross domestic product by $2.3 billion. Cumulative GDP loss from 1998 through 2010 would amount to $23.3 billion.
- Lower annual personal income by $1.2 billion. Cumulatively, personal income would be lower by $13.5 billion.
- Reduce capital formation by $7.3 billion.
- Prevent the creation of 19,000 jobs.

[See Table 9 for the economic and budgetary effects of a $1 billion increase in the corporate AMT.]

Table 9
Economic and Budgetary Effects of Increasing the Individual Alternative Minimum Tax by $1 billion

Estimates from Fiscal Associates Model.

[1] For GDP and personal income, the cumulative loss between 1998 and 2010 was divided by $13 billion ($1 billion in higher AMT for 13 years). Because capital is stock that accumulates, the loss of capital in 2010 was divided by $13 billion.

[2] Revenues are dynamic, that is, they include economic effects.

[3] Cumulative dynamic revenue gain between 1998 and 2010 divided by $13 billion in static revenue gain.

"Compliance costs are a dead-weight loss to society."

Economic and Budgetary Effects of Increasing the Individual Alternative Minimum Tax by $1 billion
(Measured as a Change from Baseline)

Effects on U.S. Economy

Year	GDP ($bil)	Personal Income ($bil)	Stock of Capital ($bil)	Employment (thous)
1998	-0.44	-0.37	-1.94	-4.0
1999	-0.84	-0.58	-2.51	-10.6
2000	-1.36	-0.94	-3.35	-18.1
2001	-1.66	-1.11	-4.25	-22.3
2002	-1.77	-1.13	-5.01	-22.4
2003	-1.77	-1.09	-5.41	-20.7
2004	-1.80	-1.08	-5.81	-19.6
2005	-1.89	-1.12	-6.18	-19.4
2006	-2.01	-1.17	-6.56	-19.6
2007	-2.09	-1.19	-6.84	-19.7
2008	-2.17	-1.22	-7.03	-19.6
2009	-2.23	-1.23	-7.17	-19.3
2010	-2.28	-1.24	-7.30	-19.0
1998-2010	-22.31	-13.48	-7.30	
Per $ of AMT[1]	**-$1.72**	**-$1.04**	**-$0.56**	

Effects on Government Budgets[2] (in $billions)

Year	Receipts			Surplus (+) or Deficit (-)		
	Federal	State & Local	Total	Federal	State & Local	Total
1998	0.98	-0.04	0.93	0.98	-0.05	0.92
1999	0.87	-0.09	0.77	0.91	-0.11	0.81
2000	0.73	-0.15	0.57	0.82	-0.18	0.64
2001	0.64	-0.19	0.45	0.77	-0.22	0.55
2002	0.63	-0.20	0.43	0.80	-0.26	0.54
2003	0.65	-0.21	0.44	0.86	-0.28	0.58
2004	0.65	-0.21	0.44	0.90	-0.31	0.59
2005	0.62	-0.22	0.40	0.92	-0.35	0.57
2006	0.60	-0.24	0.37	0.94	-0.39	0.55
2007	0.59	-0.25	0.35	0.98	-0.44	0.54
2008	0.58	-0.25	0.33	1.02	-0.49	0.53
2009	0.57	-0.26	0.31	1.06	-0.54	0.52
2010	0.56	-0.27	0.30	1.10	-0.60	0.50
1998-2010	8.67	-2.58	6.09			
Per $ of AMT[3]	**$0.67**	**-$0.20**	**$0.47**			

Again, expressing the economic effects in another way, for every dollar of *static* AMT revenue raised:

- The economy would give up 56 cents in physical assets, such as plant, machinery or equipment, that would otherwise have been sited in the United States.
- The economy would forego $1.72 in GDP.
- Of that, $1.33 are goods and services that the private business sector would have otherwise produced. Most of that output—87 cents—would have gone to compensate workers for the labor used in production. The remaining 46 cents would have gone to capital compensation in the form of depreciation and a return to investors. (Both labor and capital compensation are before tax.)

"For every dollar the government expects to raise from increasing the corporate AMT by $1 billion, the total government sector would pick up only 8 cents."

Budgetary Effects

Government forecasts assume that increasing either the corporate or individual AMT by a dollar raises a dollar. But this prediction is wrong. In fact, government gains are considerably less because lower growth means a smaller tax base and lower income, payroll, excise, sales and property taxes for federal, state and local governments. [See Tables 8 and 9.]

For every dollar the government expects to raise from increasing the corporate AMT by $1 billion:

- The federal government would raise only 43 cents.
- State and local governments would *lose* 35 cents.
- As a result, the total government sector would pick up only 8 cents.

For every dollar the government expects to raise from increasing the individual AMT by $1 billion:

- The federal government would raise only 67 cents.
- State and local governments would *lose* 20 cents.
- As a result, the total government sector would pick up 47 cents.

Summary

These results underscore the damage that the alternative minimum tax does to the economy.

"Bottom line: the AMT is an inefficient tax."

- Compliance, which diverts resources away from productive activities, is extremely expensive, amounting to at least 30 percent of what the AMT collects.
- The corporate AMT does more economic damage because it falls almost solely on capital, which is very sensitive to changes in marginal tax rates. A higher corporate AMT would discourage almost three times the capital formation and reduce growth by 66 percent more than the individual AMT.
- Labor consequences come largely from the individual AMT and would generate more than twice the employment effects as the corporate AMT.
- Bottom line: the AMT is an inefficient tax. Taking economic effects into account, the federal government will raise 57 cents less from the corporate AMT than it thinks it will raise and 33 cents less from the individual AMT.

Easing the Effects of the AMT

As previous sections have shown, the AMT is a complex, burdensome tax that imposes stiff costs on taxpayers and society while raising little revenue. Despite these costs, the AMT does not deliver on its stated purpose, that is, to assure that **all** taxpayers pay some tax. In fact, an argument can be made that the AMT detracts from tax fairness because it tends to hit businesses and individuals hardest in times of economic distress. Finally, because of its flawed structure, the AMT threatens to ensnare millions of individual taxpayers over the coming decade.

Perhaps for these reasons, members of Congress on both sides of the aisle have either pointed to problems with the AMT or put forth proposals to address them. What follows is a list of options that would address the averse effects of the AMT.

"The AMT is a complex, burdensome tax that imposes stiff costs on taxpayers and society while raising little revenue."

1. Eliminate the Corporate and Individual AMT

The most ambitious approach would be outright elimination of the corporate and individual AMT. Because the tax bills of 1993 and 1997 fixed some of the more egregious problems, eliminating the corporate AMT would carry a lower price tag, perhaps $20 billion over ten years on a static basis. Positive economic effects would pare roughly 60 percent off that amount.[30]

Because government budget projections include the dramatic expansion of the individual AMT, its outright elimination would be more expensive, roughly $75 billion over ten years. Dynamic estimates would place the costs about a third lower.[31]

2. Integrate the Corporate and Individual AMT with the Regular Tax System

At present, the AMT and the regular income tax use different definitions of taxable income. However, measuring the tax base in a consistent way could integrate the two systems. For example, the regular tax system allows taxpayers to deduct state and local taxes while the AMT does not. Tax-exempt interest on state and local bonds is not taxed under the regular system but is taxed under the AMT. Policy-makers would have to decide which treatment is the right one and apply it uniformly. Revenue estimates would depend on how and how many preferences were placed on a consistent basis.

"Because of its flawed structure, the AMT threatens to ensnare millions of individual taxpayers over the coming decade."

3. Eliminate AMT Preferences that Arise from Operating a Business

As the previous section shows, the corporate AMT does more economic damage per dollar of revenue raised than the individual AMT. However, some of the same AMT preferences that affect corporations, like depreciation, also affect individuals who run unincoporated businesses. The biggest bang for the buck (growth per dollar of tax cut) would come from removing preferences specific to operating a business, such as adjusted corporate earnings, intangible drilling costs, mining costs, research & experimental expenses, pollution control facilities and tax shelter farm activities. Growth effects would lower static estimates from about $16 billion over ten years to $7 billion.[32]

4. Index AMT Exemption and Brackets for Inflation

A good deal of political outcry will likely come from the dramatic increase in the number of individual taxpayers who will file and / or pay the AMT over the next decade. This expansion is mainly due to the fact that, unlike their counterparts in the regular tax system, the AMT exemption and bracket amounts are not indexed for inflation. Indexing the AMT for inflation would prevent many now-unaffected taxpayers from coming under its influence.

Static revenue costs would be roughly $15 billion over ten years if annual inflation runs at 2.5 percent, and dynamic costs would be a third lower.[33]

5. Raise AMT Exemption

Raising the AMT exempt amounts (currently $33,750 for single returns and $45,000 for joint) also would offer relief. A Ways and Means proposal from last year to increase AMT exemptions by $1,000 a year between 1999 and 2007 and index thereafter would have cost $15.3 billion over ten years.[34] On a dynamic basis, the cost would be about $10 billion.

Conclusion

The AMT is an expensive and inefficient way to address real or perceived equity problems of the current income tax system. Put in place in 1969, the AMT was supposed to make sure that every taxpayer paid some tax. But, today there are still individuals, some of them millionaires, who pay no income taxes. Even worse, the largest AMT penalties come during hard times, a decidedly "unfair" feature.

The alternative minimum tax costs society in two ways. First, because of its complexity, compliance costs are extremely high, amounting to at least 30 percent of what the AMT collects. Second, by raising marginal tax rates, the AMT distorts economic decisions, particularly those dealing with capital formation. As a result, for every dollar raised by the AMT, the economy forgoes between $1.72 (individual) and $2.87 (corporate) in gross domestic product.

Over the next decade, a backlash could result as one out of fourteen taxpayers come under the AMT, with the greatest effect felt by those with incomes between $50,000 and $200,000. The main reason for this expansion is because, unlike the regular income tax, the AMT is not indexed for inflation. Although the 1997 tax bill provided corporations relief with their biggest AMT headache, depreciation, more could be done to reduce the complexity and distortions associated with operating a business. As the Congress and White House consider tax cuts, they would well consider options to scale back or eliminate the alternative minimum tax.

Endnotes

1. Internal Revenue Service, *Statistics of Income Bulletin*, Summer 1997, Washington, DC, Table 1. Government projections are from Robert P. Harvey & Jerry Tempalski, "The Individual AMT: Why It Matters," *National Tax Journal*, Vol. L, No. 3, September, 1997, pp. 453-473.
2. Andrew B. Lyon, *Cracking the Code*, Washington, DC: Brookings Institution Press, 1997, p. 34. Income in $1997 was computed using the change in the CPI-U (1982-84=100), which increased from 36.7 in 1969 to 160.5 in 1997.
3. Harvey & Tempalski, p. 454.
4. Lyon, p. 35. Percentage depletion is an amortization method used for mineral deposits that allows recovery of the deposit's value over its operating life.
5. "Earned income" means wages, salaries or professional fees and other amounts received as compensation for professional services. For business owners a "reasonable" amount of profits (up to 30%) is allowed as earned income.
6. Lyon, pp. 37-38. To prevent a double cutback of preferences under the regular tax and AMT, the minimum tax was adjusted to avoid additional penalty for corporations paying the minimum tax.
7. Lyons, p. 1 and p. 140.
8. Lyons, pp. 39-42.
9. An exception would be state and local tax refunds.
10. Miscellaneous deductions are those taken on the itemized deduction Schedule A. Post-1986 depreciation refers to Modified Accelerated Cost Recovery System (MACRS) put in place by the Tax Reform Act of 1986.
11. Harvey & Tempalski, p. 457.
12. Harvey & Tempalski, pp. 457-58.
13. Harvey & Tempalski, pp. 456-58. Of 474,000 AMT returns filed, 369,000 owed AMT tax.
14. Harvey & Tempalski, pp. 462-71.

15. Note that taxpayers are not protected from increases in income due to economic growth, that is, increases over and above inflation.
16. A corporation which can not use a current loss to offset positive income in the previous three years may carry forward a net operating loss to offset future income for the next 15 years.
17. Under the AMT, net operating losses are based on AMT, not regular taxable, income in past years.
18. The combination of foreign tax credits and net operating losses may not offset more than 90 percent of the tax.
19. Internal Revenue Service, "Corporate Alternative Minimum Tax, 1987-1990," *Statistics of Income Bulletin*, Fall 1997, Washington, DC, pp. 71-76. The number of smaller firms reporting AMT increased from 16,427 in 1987 to 31,138 in 1990.
20. *SOI Bulletin*, "Corporate Alternative Minimum Tax." The percentages cited are averages for 1987 through 1990.
21. Depreciation under the regular income tax is 200-percent declining balance switching to straight-line whereas the AMT used 150-percent declining balance with a switch to straight-line.
22. Estimates from the Joint Committee on Taxation on the Chairman's Mark, June 9, 1997.
23. Arthur P. Hall, "Compliance Costs of Alternative Tax Systems II: House Ways and Means Committee Testimony," Washington, DC: Tax Foundation, *Special Brief*, March 1996. For 1996, 339,279 corporations spent an average 51.88 hours filing out form 4626 (AMT).
24. Extrapolating trends from Table 2, we estimate that about 450,000 individuals currently pay AMT taxes.
25. At best, revenue from the corporate and individual AMT is currently about $5 billion.
26. Because the corporate income tax currently picks up around $200 billion, $1 billion is 0.5% of that amount.
27. For the simulation, we assumed that the effect of the extra $1 billion in AMT from individuals was restricted to taxpayers in the 28% bracket and above.
28. The Fiscal Associates Inc. Model incorporates taxes through their effects on the returns to labor and capital. Economic effects are expressed as a change from a baseline forecast that describes how the economy would perform without any change in policy. The Model baseline, which currently has the U.S. economy growing at a long-run, real rate of 2.5 percent a year, is similar to those used by the Congressional Budget Office and the Office of Management and Budget. For more on the Model see Gary and Aldona Robbins, *Accounting for Growth: Incorporating Dynamic Analysis into Revenue Estimation*, Lewisville, TX: Institute for Policy Innovation, Policy Report No. 138, July 1996.
29. Historically, roughly two-thirds of output goes to compensate labor and the other third to capital.
30. After the changes in 1993 and 1997, the corporate AMT will probably raise somewhere around $2 billion a year. The economic offset comes from Table 8.
31. If indexed for inflation, the individual AMT would raise in the neighborhood of $5 billion a year. The Joint Committee on Taxation put the cost of an indexing proposal put forth last year at $15.3 billion over ten years. The economic offset comes from Table 9.
32. Last year, the Joint Committee on Taxation estimated the House Ways and Means Committee proposal to phase out the AMT applicable to business activities at $33.8 billion over ten years, but only a depreciation change ($18.3 billion) was enacted.
33. This is essentially the same as last year's Ways and Means proposal to raise the AMT exemption, which is discussed under option 5.
34. Estimates from the Joint Committee on Taxation on the Chairman's Mark, June 9, 1997.

About the Authors

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