Quick Study
A Policy Report Summary by the Institute for Policy Innovation

Complicating The Federal Tax Code:
A Look At The Alternative Minimum Tax (AMT)

A Summary of IPI Policy Report #145

By Gary Robbins, John M. Olin Senior Research Fellow
and Aldona Robbins, Bradley Senior Research Fellow

The Alternative Minimum Tax (AMT) is a complex, burdensome tax that imposes stiff costs on taxpayers and society while raising little revenue. Its purpose when Congress enacted it in 1969 was to ensure that all taxpayers (read wealthy) pay their "fair share" of taxes.

Yet, the AMT does not deliver on its stated purpose of tax fairness. In fact, the AMT detracts from tax fairness because it tends to hit businesses and individuals hardest in times of economic distress. It also has a flawed structure which will cause the AMT to ensnare millions of taxpayers in the coming decade, many of whom will be of modest means.

Calculating the AMT for Individuals

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

After computing AMT income, the taxpayer subtracts the appropriate AMT exemption based on income and applies higher AMT rates. Generally, the AMT results in the loss of tax credits and a higher tax bill. [For a more in depth view of calculating the individual AMT, please refer to the complete study from which this summary is drawn.]

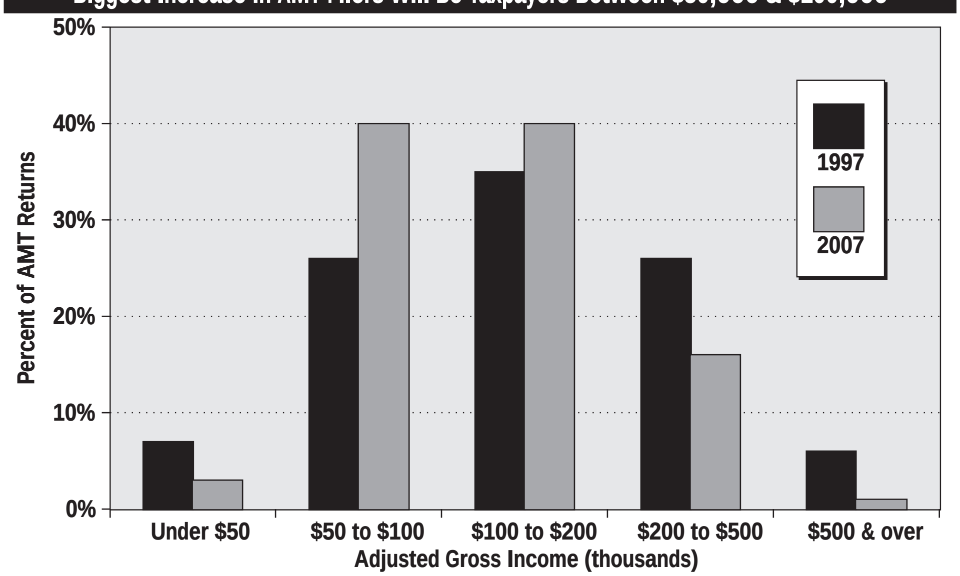
Why the AMT Will Hit More Taxpayers over Time

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 neither be "rich" nor have a lot 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. Likewise,

Figure 1

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



taxpayers with incomes between $50,000 and $200,000 will pay a larger share of AMT taxes. [See Figure 1 and Figure 2.]

Why will the burden of the AMT increasingly shift away from the "rich" to those of more modest means? AMT tax parameters are not indexed for inflation, and more and more taxpayers will 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. Inflation-indexing slows the increase in *taxable* income. Indexing of the brackets helps prevent taxpayers from being taxed at higher marginal rates. This holds down the increase in regular tax liability.

In contrast, the AMT exemption and bracket amounts are fixed and not indexed for inflation. As nominal income increases, more of it becomes taxable under the AMT, and more of taxable AMT income is taxed at the higher AMT rates.

More taxpayers, particularly the non-"rich," will have to pay the higher alternative minimum tax.

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, requiring about a dozen or more recalculations. For a more in depth look at the complexity involved with the corporate AMT, see the complete study.

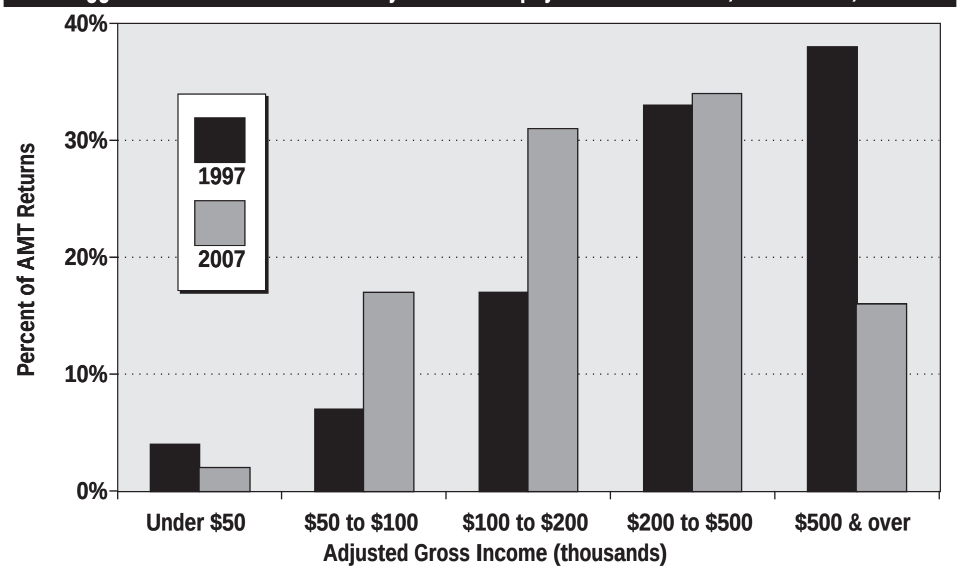
Why the AMT Is Counter-cyclical

Another unfortunate property of the 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. [See Figure 3.]

What causes this undesirable effect? During recession, the income growth of companies slows and may even decline. 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 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.

Figure 2

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



How the Individual and Corporate AMTs Affect the Economy

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

It is conservatively estimated that 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.

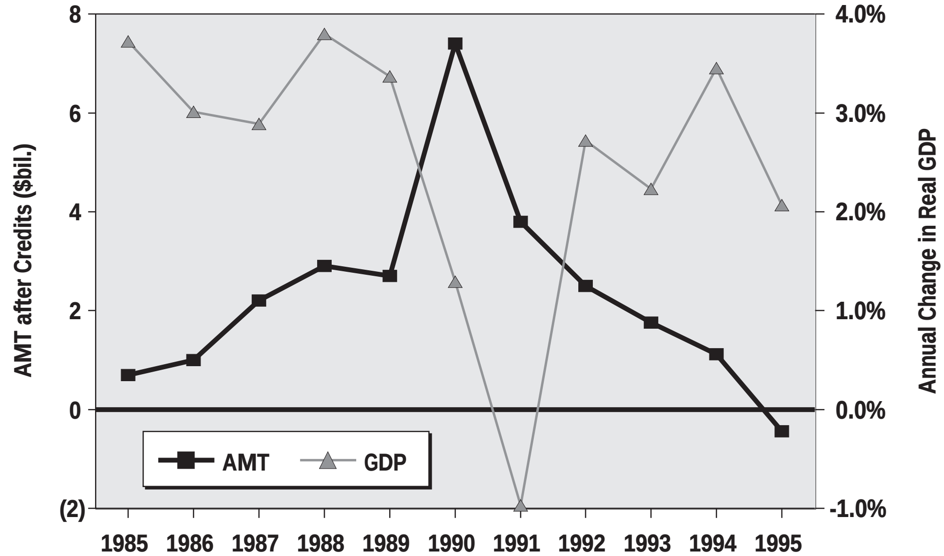
Compliance costs amounting to at least 30 percent of current AMT revenue make the AMT a very expensive tax to collect. Even worse, filling out AMT returns adds nothing to the production of goods and services. The compliance costs are a dead-weight loss to society.

Economic Effects

Although considerable, AMT compliance costs are only part of the picture. More serious is the damage to economic incentives. To estimate the economic effects of the AMT, we looked at what would happen if annual AMT taxes were raised by $1 billion.

Figure 3

Corporate AMT Goes Up In Recessions, Down During Recoveries



Increasing the Corporate AMT by $1 billion

Based on our general equilibrium model of the U.S. economy, by 2010, 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. 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.)

Increasing the Individual AMT by $1 billion

By 2010, 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.)

Budgetary Effects

Government forecasts assume that increasing either the corporate or individual AMT by a dollar raises a dollar. But this prediction is wrong. 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.

Easing the Effects of the AMT

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 adverse effects of the AMT.

1. Eliminate the Corporate and Individual AMT

This is the most ambitious approach. 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.

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.

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

Measuring the tax base in a consistent way could integrate the two systems. 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.

3. Eliminate AMT Preferences that Arise from Operating a Business

The biggest bang for the buck (growth per dollar of tax cut) would come from removing preferences specific to operating a business.

Growth effects would lower static estimates from about $16 billion over ten years to $7 billion.

4. Index AMT Exemption and Brackets 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.

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. 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. Even with the AMT, 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. 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 options to scale back or eliminate the alternative minimum tax.

Quick Study

A Policy Report Summary by the Institute for Policy Innovation

Publisher . . . . Tom Giovanetti
Editor . . . . Gary Kinman

IPI **Quick Study** is published by the Institute for Policy Innovation (IPI), a non-profit public policy organization.

Direct all inquiries to:
Institute for Policy Innovation
250 South Stemmons, Suite 215
Lewisville, TX 75067
(972) 219-0811

Email: ipi@ipi.org
Internet Website: www.ipi.org

Want More Info?

This study is a summary of IPI Policy Report # 145, *Complicating The Federal Tax Code: A Look At The Alternative Minimum Tax (AMT).*

Copies of the full study are available from our Internet Website (**www.ipi.org**), in Adobe™ Acrobat™ format. Point your browser to our website, and follow the dialogs to the Policy Reports section.

Or contact IPI at the address at left, and we'll mail you a full copy.