

The Individual Alternative Minimum Tax

Testimony submitted to
Subcommittee on Taxation and IRS Oversight
of the Committee on Finance
United States Senate

May 23, 2005

Leonard E. Burman
The Urban Institute
Tax Policy Center
Georgetown Public Policy Institute

Chairman Kyl, Ranking Member Jeffords, and Members of the Subcommittee:

Thank you for inviting me to testify today on the individual alternative minimum tax. I submit as my testimony an updated version of an article I wrote with my colleagues, William G. Gale and Jeffrey Rohaly, titled "The Expanding Reach of the Individual Alternative Minimum Tax," which was originally published in the spring 2003 issue of the *Journal of Economic Perspectives*. The article has been updated to reflect the effects of major individual income tax legislation passed through 2004, including the temporary deduction for state and local sales taxes (the newest AMT preference item), and the latest CBO economic projections.

The Expanding Reach of the Individual Alternative Minimum Tax

Updated May 2005

Leonard E. Burman, William G. Gale, and Jeffrey Rohaly

Leonard E. Burman is a senior fellow at the Urban Institute, Washington, D.C., co-director of the Tax Policy Center, and visiting professor at Georgetown University Public Policy Institute. William G. Gale is Arjay and Frances Fearing Miller Chair at the Brookings Institution, Washington, D.C., and co-director of the Tax Policy Center. Jeffrey Rohaly is a research associate at the Urban Institute, Washington, D.C., and director of tax modeling at the Tax Policy Center. This paper is an updated and revised version of Leonard E. Burman, William G. Gale, and Jeffrey Rohaly, "The Expanding Reach of the Individual Alternative Minimum Tax," *Journal of Economic Perspectives* 17 (2): 173-86 (Spring 2003). The authors gratefully acknowledge research assistance from Mohammed Adeel Saleem, helpful discussions with Jerry Tempalski and David Weiner, and comments and editorial assistance from the editors of the *Journal of Economic Perspectives*. Views expressed are those of the authors alone and do not necessarily represent the views of the Urban Institute, the Brookings Institution, their trustees, or their funders. The authors may be contacted at feedback@taxpolicycenter.org.

A. Introduction

In January 1969, Treasury Secretary Joseph W. Barr informed Congress that 155 individual taxpayers with incomes exceeding \$200,000 had paid no federal income tax in 1966. The news created a political firestorm. In 1969, members of Congress received more constituent letters about the 155 taxpayers than about the Vietnam war. Later that year, Congress created a minimum tax to prevent wealthy individuals from taking advantage of tax laws to eliminate their federal income tax liability.

Both the original minimum tax and its successor, the individual alternative minimum tax (AMT), have applied in the past to a small minority of high-income households.¹ But barring a change in law, this “class tax” will soon be a “mass tax.” Current projections show the number of AMT taxpayers skyrocketing from one million in 1999 to almost 31 million in 2010.² Without reform, virtually all upper-middle-class families with two or more children will be paying the AMT by decade’s end. The AMT is notoriously complex, and its record on fairness and efficiency is mixed at best. But because of its widening reach, fixing the AMT will be expensive. By the end of the decade, repealing the AMT will cost more than repealing the regular income tax. This paper explains how a tax originally designed to target 155 taxpayers

¹ A separate alternative minimum tax applies to corporations. See Lyon (1997).

² Throughout this paper, we compare current or recent data to projections for 2010. By the end of that year, all of the provisions of the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA), the Jobs and Growth Tax Relief Reconciliation Act of 2003 (JGTRRA), and the Working Families Tax Relief Act of 2004 (WFTRA) will have expired under current law. The resulting uncertainty about the course of tax policy means that every post-2010 projection would have to be predicated on some assumption about whether the tax rules are extended or not. If the tax cuts are extended, 46 million taxpayers will face the AMT in 2015. If, instead, they are allowed to expire as scheduled, 28.5 million taxpayers will be on the AMT in 2015. And AMT revenue will be nearly \$500 billion greater over the ten-year budget window assuming the tax cuts are extended than if they expire in 2010.

could grow to cover 31 million, discusses economic issues related to the alternative minimum tax, and examines options for reform.³

B. How the Alternative Minimum Tax Works

Taxpayers who may be subject to the alternative minimum tax must calculate their tax liability twice: once under regular income tax rules and again under AMT rules. If liability under the AMT proves higher, taxpayers pay the difference as a surcharge to the regular tax. Technically, the difference paid is their AMT.

To calculate the alternative minimum tax, taxpayers add to their regular taxable income various items that are paradoxically called “AMT preferences,” and that fall into two categories. *Exemption preferences* allow taxpayers a variety of deductions, exclusions or credits in the regular tax, but are not allowed in the AMT. These items include personal exemptions, the standard deduction, and itemized deductions for state taxes and miscellaneous expenses. Middle-income taxpayers are the most likely to be hit by exemption preferences, which have little to do with tax sheltering. As a result, these adjustments are difficult to justify.

Deferral preferences allow taxpayers to postpone regular income tax payments or shelter income by hastening deductions or delaying income recognition. The AMT rules limit the extent to which taxpayers can use deferrals by, for example, allowing less generous depreciation deductions. Compared with exemption preferences, deferral preferences are more complex, have a greater tendency to affect high-income filers, and generate less AMT revenue.

³ This paper draws from Burman et al. (2002); Burman, Gale, and Rohaly (2003); and Burman et al. (2004). The interested reader might also read Graetz and Sunley (1988), Harvey and Tempalski (1997), JCT (1970, 2001a), JEC (2001) Karlinsky (1995), Kiefer et al. (2002), Rebelein and Tempalski (2000), Shaviro (2001), and Tempalski (1996).

Once a taxpayer adds in all applicable preferences and tallies income, the next step is to subtract the alternative minimum tax exemption—currently \$58,000 for married couples and \$40,250 for singles. The remaining income level is then taxed at flatter rates than under the regular income tax. The statutory AMT tax rate of 26 percent applies to the first \$175,000 of net income above the exemption. For income over that level, a 28 percent tax rate applies. Under the regular income tax (in 2005), the same income would be taxed at rates ranging from 10 percent to 35 percent. Many taxpayers' effective AMT rate, however, is significantly higher than the top statutory AMT rate of 28 percent, because the AMT exemption itself phases out at a 25 percent rate over higher income ranges. Thus, effective marginal tax rates under the AMT can be as high as 35 percent (1.25 times 28 percent). The AMT exemptions and tax brackets are not indexed for inflation.⁴

C. Class Tax to Mass Tax

Under current law, about 31 million people will be paying the alternative minimum tax by 2010, almost 9 times as many as in 2005, as shown in table 1.⁵ The increase in coverage will

⁴ The alternative minimum tax generally preserves the lower tax rates on capital gains and dividends in the regular tax. Current law limits tax rates on long-term capital gains and qualifying dividends to 5 percent for low- and moderate-income taxpayers and 15 percent for others. Those limits apply to both the regular income tax and the AMT and are scheduled to expire at the end of 2008 under current law. Unless provisions in JGTRRA are extended, dividends will revert to being taxed as ordinary income and the rate on long-term capital gains will return to 20 percent (10 percent for lower-income taxpayers) in 2009.

⁵ Unless otherwise noted, all of the projections in this paper derive from the Tax Policy Center (TPC) Microsimulation Model. The model is based on data from the 2001 public-use file produced by the Statistics of Income Division of the Internal Revenue Service. The file contains about 143,000 records with detailed information from federal individual income tax returns filed in the 2001 calendar year. A constrained statistical match with the March 2002 Current Population Survey provides demographic and other information to supplement the tax data. The tax model has two components: a statistical routine that uses forecasts from the Congressional Budget Office to "age" or extrapolate the 2001 data to create representative samples of the population for future years; and a detailed tax calculator that computes the regular income tax and AMT liability for all tax units in the sample under current law and under alternative policy proposals. For details on the model's methodology, see Rohaly, Carasso, and Saleem (2005).

occur in all but the very lowest income classes. In 2005, for example, 1 percent of filers with income between \$75,000 and \$100,000 (in 2005 dollars) face the AMT; by 2010, 49 percent of filers in that income range will pay the AMT. The AMT will become the de facto tax system for filers in the income range of \$200,000 to \$500,000, 94 percent of whom will face the tax in 2010. At very high income levels, the share of taxpayers on the AMT falls, because the top AMT rate is lower than the top marginal tax rate in the regular income tax. As a result, as income rises, eventually regular income tax liability overtakes AMT liability. Even so, in 2010 more than one-third of tax filers with incomes above \$1 million will pay the AMT, up from 25 percent in 2005.

Because the alternative minimum tax does not allow exemptions for dependents or deductions for state taxes, it will impose particularly high burdens on taxpayers with children and those in high-tax states.⁶ Because the AMT exemption for couples is less than double the exemption for singles and because the tax brackets are not adjusted for marital status, the AMT imposes significant marriage penalties. In combination, these issues can raise AMT participation rates dramatically, as spelled out in table 2. By 2010, among married couples with two or more children and income between \$75,000 and \$100,000, 89 percent will face the AMT.

More generally, the expansion of the AMT implies that by 2010 more than half of all tax filers will be unaffected by marginal tax rate changes in the regular income tax—45 percent of those because they are on the AMT and 55 percent because their incomes are too low to owe

⁶ The American Jobs Creation Act of 2004 provided a deduction for state and local general sales taxes that is incorporated in the TPC microsimulation model. As with the deductions for state and local income and property taxes, the deduction for sales taxes is an AMT preference item. Under current law, the sales tax deduction is scheduled to expire at the end of 2005.

regular income tax. Sixty-two percent of married couples will find themselves in that situation—almost three-quarters of them because of the AMT.

Perhaps the most striking illustration of the growing scope of the AMT is that by 2010, almost half of all income will be taxed under the AMT and repealing the regular income tax would reduce tax revenues by less than repealing the AMT. In 2010, total income tax revenues are projected to be \$1,291 billion -- \$1,179 billion from the regular income tax and \$112 billion from the AMT (defined as the amount owed above and beyond regular tax liability). AMT repeal would thus reduce revenues by \$112 billion in 2010. If the regular income tax were repealed, AMT revenues would increase dramatically to \$1,240 billion, so the net revenue loss would be only \$51 billion (= \$1,291 billion – \$1,240 billion). The number of AMT taxpayers would more than double to 70 million as even moderate-income taxpayers would face AMT liability.

Determining the causes of the expanding reach of the AMT is tricky. For example, the AMT might have been repealed in 1979, but it wasn't. Thus, in some sense, failure to repeal the AMT in 1979 could be viewed as the cause of projected AMT growth. Despite this underlying ambiguity, we believe it makes the most sense to focus on two factors: the lack of inflation indexing in the AMT and the 2001-2004 tax cuts. As a general rule, most major tax legislation since 1980 has included changes in the AMT that broadly conform to the reforms made in the regular income tax--the 1986 act, for example, broadened the base of both taxes; the 1993 act raised marginal rates under both taxes. There are four major exceptions to the general rule, though. The Economic Recovery Tax Act of 1981 cut taxes and indexed the regular tax system for inflation but did not index the AMT. More recently, the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA), the Jobs and Growth Tax Relief Reconciliation Act of

2003 (JGTRRA), and the Working Families Tax Relief Act of 2004 (WFTRA) cut the regular income tax, but did not make significant, lasting changes to the AMT.⁷ Our simulations show that if the AMT had been indexed for inflation along with the regular income tax in 1985, and if the 2001-2004 tax cuts had not been enacted, the number of AMT taxpayers would have remained between 300,000 and 400,000 through 2010, rather than rising to 31 million.

The 2001-2004 tax acts more than doubled the projected number of those who face the alternative minimum tax in 2010, as shown in the third column of table 1. Before this legislation, 14 percent of taxpayers were slated to pay the AMT in 2010 (with the rise over time due primarily to the lack of inflation indexing); afterwards, 31 percent will pay the AMT. In addition, by 2010, the recent tax cuts will more than double the share of adjusted gross income (AGI) subject to the AMT from 22 percent to 50 percent, and the laws will almost triple the cost of eliminating the AMT from \$40 billion to \$112 billion.

Ironically, just as the tax cuts made the AMT problem worse, the AMT will undo some of the effects of the 2001-2004 acts. By 2010, the AMT will “take back” about 29 percent of the overall income tax cut, including more than 71 percent of the cut targeted to taxpayers with income between \$200,000 and \$500,000, as shown in table 1.⁸

⁷ Lindsey (2001) blames the 1993 tax measures for much of the growth in AMT participation, but our estimates suggest that those effects were much smaller than those attributable to EGTRRA, in large part because the 1993 act raised the highest income tax rates whereas EGTRRA reduced marginal tax rates.

⁸ Policymakers understood these effects at the time. Some have claimed that the AMT was left unadjusted precisely in order to reduce artificially the revenue costs and mitigate the reported distributional effects of the tax. Gale and Potter (2002) discuss these issues further.

D. Equity

The alternative minimum tax was originally motivated by a minimalist notion of vertical equity—that high-income people should pay at least some income tax each year. The logic of such a goal is questionable on purely economic grounds, but it commands substantial public support, as the 1969 letter-writing campaign suggests.

The alternative minimum tax has succeeded in holding down the number of high income tax filers who pay no federal income tax. We estimate that in 2005, roughly 1,600 tax filers with incomes above \$1 million will pay no federal income tax, but at least 7,600 high-income tax filers would owe no income tax without the AMT. If the existence of the AMT also discourages taxpayers from attempting to shelter income, the number paying no income taxes without an AMT could be much higher. Nevertheless, it is unclear why a few million people need to pay the tax currently in order to stop a few thousand from paying no tax.

Moreover, although the AMT is more progressive than the income tax, it will become less progressive over time as it comes to affect millions of middle-class families. Filers with income under \$100,000 (in 2005 dollars) will account for 37 percent of AMT taxpayers in 2010, up from 6 percent in 2005. Those filers will account for 11 percent of AMT revenues, compared with less than one percent in 2005. Only 18 percent of AMT revenues will come from taxpayers with incomes above \$500,000 in 2010, compared with 31 percent in 2005. That income group will account for 34 percent of income tax revenues in 2005 and 31 percent in 2010. Thus, the AMT's ability to boost the progressivity of the income tax will erode in the future.

The alternative minimum tax also raises horizontal equity issues. On the one hand, to the extent that it reins in tax shelters, the AMT reduces the variance of average effective tax rates among taxpayers with similar incomes. On the other hand, the AMT affects taxpayers with

similar incomes but different family circumstances or different state of residence differently, raising the variance of after-tax income. Our calculations show that, on balance, the AMT actually increases the variance by four percent for taxpayers with incomes between \$200,000 and \$500,000 in 2005. By 2010, the AMT will increase the variance of effective tax rates by over 17 percent for such taxpayers, although it will reduce the variance slightly for those earning between \$50,000 and \$75,000. Moreover, a full measure of horizontal equity must adjust for differences in ability to pay tax created by factors other than income; specifically, it might include adjustments for factors like charitable contributions or extraordinary medical expenses that are now written into the regular tax code. The AMT allows some of these adjustments, such as deductions for charitable contributions and casualty losses, but disallows others, such as child exemptions and deductions for certain medical expenses. It also significantly increases marriage penalties. Thus, a judgment on how the AMT affects horizontal equity will necessarily involve considering which elements of the current tax code are necessary to reflect ability to pay.

E. Efficiency

The most plausible economic rationale for a minimum tax of some sort is that it could be a second-best backstop for a porous income tax. By reining in unwarranted tax shelters that lawmakers for some reason could not address directly, the tax might reduce distortions and limit tax sheltering. For example, by taxing interest income from bonds that state and local governments issue to support private activities like shopping centers or stadiums, income that is exempt from the regular income tax, the AMT reduces the subsidy afforded such investments (Leonard 1998). Under certain assumptions, this could make the tax system more efficient.

Although the notion of the AMT as a base-broadening, rate-lowering tax was plausible in the past, it is not today. In the early years of the alternative minimum tax, shelters were booming. Shelters served to reduce or eliminate taxes for many high-income filers and typically worked by combining assets that generated capital gains and expenses that were deductible.

Tax on capital gains could be deferred for years and faced a low statutory rate when recognized. Deductions included highly accelerated depreciation, generous oil depletion allowances, and interest payments that largely represented inflation rather than the real cost of funds (Graetz 1997). Thus an investment that would lose money before tax—because the income including capital gains was less than the expense—could be profitable after tax because expenses were overstated for tax purposes and capital gains were only partially taxed. The AMT likely limited those shelters and arguably improved economic neutrality in large part by reducing the generosity of the deductions and taxing capital gains at the same rate as other income. Prior to 1985, about 85 percent of AMT preferences related to capital gains.

The alternative minimum tax, however, no longer focuses mainly on tax shelters. A much larger share of its revenue now comes from run-of-the-mill provisions like the disallowance of personal exemptions and standard deductions.⁹ The Tax Reform Act of 1986 combined with the near-elimination of inflation sharply curtailed tax shelter activity (Samwick, 1995). Because the 1986 tax reform taxed capital gains at the same rate as ordinary income, capital gains were eliminated as an AMT preference item. When tax preferences for capital gains were re-established in 1990 and expanded in 1997, the role of capital gains in sheltering income rose, but capital gains were not reinstated as an AMT preference item. Thus, the

⁹ Burman and Weiner (2005) provide a breakdown of the relative importance of the different AMT adjustments and preferences in reconciling taxable income under the regular tax and the AMT. In 2002, personal exemptions alone accounted for more than 20 percent of the difference.

preferential treatment of capital gains, the linchpin of many sheltering schemes, is not addressed at all in the AMT.

Finally, one of the enduring bits of conventional wisdom about the alternative minimum tax is that, whatever its other faults, it taxes a broader base of income at lower marginal rates than the regular income tax. The facts are almost exactly reversed; that is, the AMT often results in less income subject to tax but at higher marginal rates than under the regular income tax. For example, a couple earning \$85,000 with six children would have \$49,400 of taxable income under the regular tax in 2005, assuming that they took the standard deduction.¹⁰ Neither the personal exemptions nor standard deduction would be allowed against the AMT, but the couple would be entitled to an AMT exemption of \$58,000, yielding income subject to the AMT of \$27,000—less than the taxable income under the regular tax. They would nevertheless owe AMT because their marginal tax rate under the AMT—26 percent—is much higher than their regular income tax bracket of 15 percent. Over time, more and more taxpayers will find themselves in a similar position. The share of AMT taxpayers with less income taxed in the AMT than in the regular income tax is projected to rise from 70 percent in 2005 to 87 percent in 2010. The share with higher marginal tax rates under the AMT than under the regular tax will rise from 71 percent in 2005 to more than 92 percent in 2010.

F. Complexity

The National Taxpayer Advocate (2001) and the Internal Revenue Service (2000) have called the alternative minimum tax one of the most difficult and complex areas of tax law. Many

¹⁰ Taxable income would equal \$85,000 minus \$25,600 in personal exemptions (8 times \$3,200 per person) minus a standard deduction of \$10,000, which equals \$49,400.

taxpayers must keep two separate sets of books because of the deferral preferences--the AMT rules on the timing of income recognition and deductions that differ from regular income tax rules. These rules reduce the number of high-income tax filers that pay no income tax and thus serve an identifiable goal. The same goal could be advanced much more simply, however, by scaling back deferral preferences in the regular tax, rather than requiring taxpayers to juggle two separate, complicated calculations.

Much of the rest of AMT complexity appears to be completely pointless. Most people who must currently fill out the AMT forms end up owing no additional tax. Increasingly, the tax will impose greater compliance burdens on middle-class taxpayers, a group that was never the tax's main target. Moreover, the complexity also makes predicting marginal tax rates and understanding tax rules much more difficult.

G. Options for Reform

The underlying goals of the AMT—requiring high-income people to pay some tax, deterring the aggressive use of tax shelters, and ensuring progressivity—have widespread popular appeal, but the tax itself is replete with problems. A variety of reform options could, to varying degrees, keep the baby but throw out the bathwater.

Reducing the AMT

Merely indexing the AMT for inflation would reduce the number of AMT taxpayers in 2010 by 82.5 percent overall and by 98 percent for middle-class taxpayers, defined as those with cash income between \$50,000 and \$75,000. Indexing would reduce revenues by \$431.5 billion through 2015 under current law (table 3).

The middle class could be almost entirely removed from the AMT by also allowing dependent personal exemptions and nonrefundable credits, such as the tax credits for child care and education. In conjunction with indexing, these reforms would reduce the number of AMT taxpayers in 2010 by 86.5 percent overall and by more than 99 percent among those with incomes between \$50,000 and \$75,000.

Combining these reforms with two additional steps -- repealing the phaseout of the AMT exemption and allowing deductions for state and local taxes, miscellaneous expenses, and medical expenses allowed under the regular tax -- would eliminate all of the major exemption preferences and virtually end the AMT for all but very high-income tax filers. The number of AMT taxpayers would fall by more than 99 percent relative to current law. The additional steps primarily benefit high-income households; for example, they would reduce the number of AMT taxpayers with income between \$500,000 and \$1 million by almost 94 percent. The additional measures are also expensive. The ten-year revenue cost would be \$614 billion, more than 40 percent greater than indexing alone.

From here, outright repeal of the AMT is a small step, consisting mainly of the elimination of the deferral preferences. Relative to the plan above, repeal would cost just \$56 billion more over the decade and reduce the number of AMT payers in 2010 by an additional 0.3 million. Repeal of the deferral preferences would be significantly regressive, however, with very large tax cuts going to the highest-income households (Burman et al. 2004).

Repealing the deferral preferences would also significantly increase the number of high-income filers who pay no income tax. The number of filers with income above \$1 million who

would pay no income tax would rise from 3,700 under the plan above to 9,100 under repeal.¹¹

These figures show the power of the deferral preferences in reducing the number of high-income filers who pay no tax. Even more nontaxpayers would exist (and the revenue costs would be larger) if AMT repeal unleashed a rash of new tax shelters.

Revenue neutral reform

All of the plans noted above would significantly reduce revenues over the next decade and by increasing amounts beyond that.¹² In the current budgetary environment, such changes may be neither feasible nor desirable (See Auerbach et al. 2003). AMT reform could be financed by retargeting the tax or by coupling AMT repeal with income tax changes.

One way to retarget the AMT at very high-income taxpayers and aggressive tax shelterers would be to allow dependent exemptions and personal nonrefundable tax credits, eliminate the AMT exemption phaseout, and index the exemption from its 2005 level starting in 2006. These reforms could be paid for by increasing the 28 percent AMT bracket to 33.5 percent (which would increase taxes only for those with incomes above the AMT exemption phaseout, an income level of \$330,000 for couples after 2005) and eliminating the preferential rates for capital gains and dividends under the AMT.

As shown in table 3, under current law, the proposal would raise about \$9 billion over the next ten years. The proposal would be highly progressive, cutting overall taxes on those with incomes under \$500,000 and raising taxes on higher income filers. It would reduce the number

¹¹ The number of filers with income above \$200,000 who pay no income tax would rise from 51,300 under the plan above to 105,700 with repeal.

¹² If the 2001-2004 tax cuts were made permanent, the revenue losses due to AMT reform would rise. Indexing and repeal would reduce revenues by about \$747 billion and \$1.11 trillion, respectively, through 2015. These estimates omit the added debt service costs that the government would owe if revenue fell.

of AMT taxpayers in 2010 by 90 percent—99 percent for those with incomes between \$50,000 and \$75,000. But it would decrease the number of AMT taxpayers among those with incomes between \$500,000 and \$1 million by only 8 percent. Although not shown in the table, it would more than double the number of taxpayers with incomes over \$1 million subject to the tax.

If there is to be an alternative minimum tax, this option has much to recommend it. Allowing preferential capital gains tax rates under the AMT is also a major source of complexity and sheltering. Many individual tax shelters are designed to exploit the difference between the tax rates on capital gains and the tax rates on other income and expense—most notably the higher effective tax rate on interest expense (Burman 1999). The deduction for investment interest is the most important factor explaining the nontaxation of high-income returns (Balkovic 2002). Thus, taxing capital gains the same as other income under the AMT could arguably enhance efficiency, equity, and simplicity, and raise revenue that could be used to reduce the number of AMT taxpayers.

Instead, if legislators could find the revenue and resolve to finance AMT repeal, the best option would be to incorporate directly into the regular income tax whatever AMT provisions are deemed good tax policy, while adjusting the rates and tax in the regular income tax to achieve revenue neutrality and distributional neutrality. For example, if the regular income tax deductions for state and local taxes and the depreciation rules are too generous, reformers could eliminate these provisions for all taxpayers, not just for those paying the AMT.¹³ Inevitably, many taxpayers would face higher marginal and average tax rates under a revenue-neutral

¹³ In fact, eliminating the regular income tax deduction for state and local taxes would more than pay for repealing the AMT, if the 2001-2004 tax cuts expire as scheduled, although the option would lose revenue if the tax cuts are extended.

package. But replacing the hodge-podge of implicit taxes created by the AMT with well-designed explicit taxes under the regular income tax would make the tax system fairer, simpler, and more efficient without spawning shelters or sacrificing tax revenues.

Table 4 shows the tax rates that would be necessary in the regular income tax to finance a revenue-neutral repeal of the AMT in 2010. Raising all statutory tax rates by the same proportion would require an increase of more than 9 percent, bringing the top rate to 38.3 percent compared to its current-law value of 35 percent. Raising only the top three rates would require a 15 percent increase and a top rate of 44 percent. Although these changes would be revenue neutral, they would involve shifting tax burdens across income classes. Alternatively, it would be possible to mimic the distribution of average tax burdens under current law without the AMT. If taxpayers in each bracket were to make the same aggregate tax payment in 2010 after the elimination of the AMT as they would under current law, the 10 percent tax rate would have to be raised to 10.1 percent, the 15 percent tax rate to 16.3 percent, the 25 percent tax rate to 28.3 percent, the 28 percent tax rate to 34 percent, the 33 percent rate to 42.3 percent, and the 35 percent tax rate would be *lowered* to 33.8 percent. That is, the statutory regular income tax rate would have to rise for those in the bottom five brackets and fall in the highest income group.

H. Why Not Repeal the Regular Tax?

By 2010, it would cost more to repeal the alternative minimum tax than to repeal the regular income tax. Some commentators have suggested, with varying degrees of seriousness,

that the regular tax be repealed and the AMT kept on. We believe this would be a major mistake.¹⁴

If the alternative minimum tax were to become the only income tax, it is unlikely that it could (or should) remain in its current structure. The tax is not indexed for inflation. It is laced with marriage penalties and child penalties. A tax based on ability to pay should have an adjustment for family size, which suggests that personal exemptions should be allowed.

Those who favor a flat tax should be clear that the alternative minimum tax is not a shortcut to that goal. After all, the AMT includes all the aspects of the regular income tax that are not explicitly erased by the adjustments under the AMT. The alternative minimum tax includes four different tax brackets (including the effect of the phaseout of the exemption) at rates of 26, 32.5, 35, and 28 percent. And it would certainly not be simple.

I. Conclusion

Lack of inflation indexing in the alternative minimum tax expands the reach of the tax each year. Meanwhile, the 2001-2004 tax cuts reduce regular income tax burdens over time. Caught amid these trends, one in three American taxpayers will soon be squeezed by a problematic tax that almost none of them were ever meant to pay. To date, neither political party has been willing to shoulder the responsibility for addressing the problem. But as the reach of the alternative minimum tax expands to encompass ever more taxpayers, the political benefits of seeking out a solution will expand as well.

¹⁴ The issues in replacing the regular tax with the AMT are discussed in Burman and Weiner (2005).

References

- Auerbach, Alan J., William G. Gale, Peter R. Orszag, Samara R. Potter. 2003. "Budget Blues: The Fiscal Outlook and Options for Reform." In *Agenda for the Nation*, edited by Henry J. Aaron, James Lindsey, and Pietro Nivola. Washington, DC: Brookings Institution Press.
- Balkovic, Brian. 2002. "High-Income Tax Returns for 1999." *Statistics of Income Bulletin* (Internal Revenue Service), Spring 2002: 7–58.
- Barr, Joseph W. 1969. "Statement by Joseph W. Barr." In *Hearings on the 1969 Economic Report of the President before the Joint Economic Committee*. Washington, DC: U.S. Government Printing Office.
- Burman, Leonard E. 1999. *The Labyrinth of Capital Gains Tax Policy: A Guide for the Perplexed*. Washington, DC: Brookings Institution Press.
- Burman, Leonard E., and David Weiner. 2005. "Suppose They Took the AM Out of the AMT?" In *Proceedings of the National Tax Association 97th Annual Conference on Taxation*. Washington, DC: National Tax Association.
- Burman, Leonard E., William G. Gale, and Jeffrey Rohaly. 2003. "The AMT: Projections and Problems." *Tax Notes* 100 (1) (July 7): 105–17.
- Burman, Leonard E., William G. Gale, Mathew Hall, Jeffrey Rohaly, and Mohammed Adeel Saleem. 2004. "The Individual Alternative Minimum Tax: A Data Update." Washington, DC: The Urban Institute. <http://www.urban.org/url.cfm?ID=411051>.
- Burman, Leonard E., William G. Gale, Jeffrey Rohaly, and Benjamin H. Harris. 2002. "The Individual AMT: Problems and Potential Solutions." *National Tax Journal* 55(3): 555–96. Also available as Urban-Brookings Tax Policy Center Discussion Paper No. 5, September.
- Gale, William G., and Samara R. Potter. 2002. "An Economic Evaluation of the Economic Growth and Tax Relief Reconciliation Act of 2001." *National Tax Journal* 55(1): 133–86.
- Graetz, Michael J. 1997. *The Decline (and Fall?) of the Income Tax*. New York: W.W. Norton & Company.
- Graetz, Michael J., and Emil Sunley. 1988. "Minimum Taxes and Comprehensive Tax Reform." In *Uneasy Compromise: Problems of a Hybrid Income-Consumption Tax*, edited by Henry J. Aaron, Harvey Galper, and Joseph Pechman (385–419). Washington, DC: Brookings Institution Press.
- Gruber, Jon, and Emmanuel Saez. 2000. "The Elasticity of Taxable Income: Evidence and Implications." NBER Working Paper 7512. Cambridge, MA: National Bureau of Economic Research.

Harvey, Robert P., and Jerry Tempalski. 1997. "The Individual AMT: Why It Matters." *National Tax Journal* 50(3): 453–73.

Internal Revenue Service. 2000. "Annual Report from the Commissioner of the Internal Revenue Service on Tax Law Complexity." Washington, DC: Internal Revenue Service.

Joint Committee on Taxation. 1970. "General Explanation of the Tax Reform Act of 1969." JCS-16-70. Washington, DC: Joint Committee on Taxation.

———. 2001a. "Study of the Overall State of the Federal Tax System and Recommendations for Simplification, Pursuant to Section 8022(3)(B) of the Federal Tax System." JCS-03-01. Washington, DC: Joint Committee on Taxation.

———. 2001b. "Estimated Budget Effects of the Conference Agreement for H.R. 1836 [1]." JCX-51-01. Washington, DC: Joint Committee on Taxation.

Joint Economic Committee. 2001. "The Alternative Minimum Tax for Individuals: A Growing Burden." Washington, DC: Joint Economic Committee.

Karlinsky, Stewart. 1995. "A Report on Reforming the Alternative Minimum Tax System." *The American Journal of Tax Policy* 12(1): 139–50.

Kiefer, Donald, Robert Carroll, Janet Holtzblatt, Allen Lerman, Janet McCubbin, David Richardson, and Jerry Tempalski. 2002. "The Economic Growth and Tax Relief Reconciliation Act of 2001: Overview and Assessment of Effects on Taxpayers." *National Tax Journal* 55(1): 89–117.

Leonard, Paul A. 1998. "Tax-Induced Segmentation in the Tax Exempt Securities Market." *Quarterly Journal of Business and Economics* 37(4): 27–47.

Lindsey, Lawrence B. 2001. "Governor Bush's Proposal and the Alternative Minimum Tax." *Tax Notes* 86(4): 553–57.

Lyon, Andrew B. 1997. *Cracking the Code: Making Sense of the Corporate Alternative Minimum Tax*. Washington, DC: Brookings Institution Press.

Mirrlees, James A. 1971. "An Exploration in the Theory of Optimal Income Taxation." *Review of Economic Studies* 38:175–208.

National Taxpayer Advocate. 2001. "National Taxpayer Advocate's Fiscal Year 2001 Annual Report to Congress." Washington, DC: Internal Revenue Service.

Rebelein, Robert, and Jerry Tempalski. 2000. "Who Pays the Individual AMT?" OTA Paper 87. Washington, DC: Office of Tax Analysis.

Rohaly, Jeffrey, Adam Carasso, and Mohammed Adeel Saleem. 2005. "The Urban-Brookings Tax Policy Center Microsimulation Model: Documentation and Methodology for Version 0304." Washington DC: The Urban Institute.
<http://taxpolicycenter.org/publications/template.cfm?PubID=9168>.

Shaviro, Daniel. 2001. "Tax Simplification and the Alternative Minimum Tax." *Tax Notes* 91(10): 1455–68.

Slemrod, Joel. 1990. "Optimal Taxation and Optimal Tax Systems." *Journal of Economic Perspectives* 4(1): 157–178.

Steuerle, Gene. 2001. "Moving Beyond the Fight over the Alternative Minimum Tax." *Tax Notes* 91(14): 2067–8.

Tempalski, Jerry. 1996. "The Individual Minimum Tax." Washington, DC: U.S. Department of the Treasury.