The Alternative Minimum Tax Corrodes Both the Tax System and the Democratic Process

DEFINITION OF PROBLEM

The individual Alternative Minimum Tax (AMT) was originally enacted to ensure wealthy persons paid at least some tax. Because the AMT is not indexed for inflation, limited to high income taxpayers, or focused on tax loopholes, however, it increasingly penalizes middle income taxpayers for having children, getting married, or paying state and local taxes while allowing thousands of millionaires to pay no tax at all.

The AMT is complicated and burdensome, even for those who are not subject to it. Many taxpayers must fill out the lengthy AMT form only to find they owe little or no AMT after all. Others must complete the form just to claim certain tax credits. The AMT requires taxpayers to compute their taxes twice — once under the regular tax rules and again under the AMT rules. If the “tentative minimum tax” (or tentative AMT) liability exceeds the regular tax liability, the taxpayer pays the difference as AMT. Thus, the AMT reduces the transparency of the tax system, making it more difficult for nearly everyone to predict what they will owe.

As if the AMT were not complicated enough, Congress regularly passes so-called AMT "patches" to temporarily protect middle-class taxpayers and popular tax benefits, typically at the last minute or on a retroactive basis. Last-minute patches sometimes delay urgently needed tax refunds because with every change in law the IRS has to update its systems before processing returns. Because IRS systems assume a patch will be enacted in 2012, if Congress does not enact a patch, as expected, return processing will be delayed for 80 to 100 million taxpayers - more than half of all filers - and about 33 million taxpayers

could pay AMT. Many taxpayers will also face estimated tax shortfalls and underpayment penalties.

The AMT is difficult to repeal because it is projected to raise a large amount of revenue. However, AMT patches have always prevented the AMT from raising these projected amounts. What we have, in essence, is one law that grants popular tax benefits (the regular tax code), another law that eliminates the benefits (the AMT), and then yet a third law that undoes the elimination of benefits (the patches), usually at the last minute — a legislative Rube Goldberg contraption of unnecessary complexity.

In addition, the AMT reduces the transparency of the tax reform debate. For example, anyone proposing a tax cut has to determine whether the AMT will recapture the cut, and if so, whether to allow the cut to appear deceptively inexpensive because the AMT claws it back or to propose additional and costly changes to mitigate the AMT. Further, any revenue estimate for a tax reform proposal will have to be compared to the illusory revenue that supposedly will be collected after expiration of the AMT patch under current law — even though no one believes Congress will let the patch expire. In this way, the AMT corrodes both the tax system and the democratic process.

**ANALYSIS OF PROBLEM**

**The AMT does not achieve its original goal.**

Congress enacted a minimum tax (the predecessor of today’s Alternative Minimum Tax or “AMT”) after hearing testimony that 155 taxpayers with adjusted gross incomes (AGI) above $200,000 (about $1,427,882 in 2012 dollars) paid no federal income tax for the 1966 tax year, due to tax preferences or loopholes. Remarkably, the AMT today does not achieve its original goal of ensuring that all wealthy persons pay income tax. In 2009 (the most recent year for which complete data is available), nearly 21,000 taxpayers with adjusted gross incomes (AGI) of more than $200,000 paid no income tax at all — over 35,000 taxpayers if you use a more expanded definition of income than AGI.

Perhaps more remarkably, the AMT will soon hit a much higher percentage of middle income and upper-middle income taxpayers than wealthy taxpayers. In 2013, absent another patch, the AMT is projected to affect an estimated 33 percent of taxpayers with
incomes between $75,000 and $100,000 and 44 percent of taxpayers with incomes between $100,000 and $200,000 — yet only 14 percent of taxpayers with incomes above $1 million.\(^8\)

The AMT hits middle-income taxpayers for getting married, having children, and paying state and local taxes.

Because the AMT exemption amount is not indexed for inflation, and the AMT is not limited to high income taxpayers, or focused on loopholes, it increasingly hits taxpayers who have not done any tax planning. This is largely because the AMT eliminates the tax “benefit” of children (dependency exemptions are lost under the AMT) and marriage (the AMT contains marriage penalties), and does not allow a deduction for state and local taxes.\(^9\)

As a result, 84 percent of married couples with two or more children and adjusted gross income between $75,000 and $100,000 will be hit by the AMT in 2012, up from 0.2 percent in 2011, unless Congress enacts retroactive legislation.\(^10\) While it is hard to imagine that the drafters of the original AMT provision would view incurring expenses to raise a family or living in a high-tax state as a tax-avoidance loophole, that is essentially the way those expenses are viewed under today’s AMT.

More than 35,000 taxpayers with incomes above $200,000 pay no income tax despite the AMT.

More than 35,000 taxpayers with incomes of more than $200,000 paid no income tax in 2009, and one projection estimated that about 7,000 millionaires reportedly paid no income tax in 2011.\(^11\) One reason for this is the exclusion of interest on certain tax-exempt bonds (and certain miscellaneous itemized deductions) under both regular tax and the AMT.\(^12\) For example, wealthy individuals who invest in certain tax exempt municipal bonds generally pay no federal income tax on the interest they receive.

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\(^12\) Justin Bryan, High-Income Tax Returns for 2009, 31 SOI Bulletin 6, 15-17 (Spring 2012), http://www.irs.gov/pub/irs-soi/12soisprbul.pdf (“nontaxable returns under the expanded income concept, were much more likely to have tax-exempt interest than were taxable returns. Similarly, nontaxable returns were much less likely to have any income from salaries and wages. Because they do not generate AMT adjustments or preferences, tax-exempt bond interest, itemized deductions for interest expense, miscellaneous itemized deductions not subject to the 2-percent-of-AGI floor, casualty or theft losses, and medical expenses (exceeding 10 percent of AGI) could, by themselves, produce nontaxability”); Derek Thompson, Buffett Rule Rorschach: 7,000 Millionaires Paid No Income Taxes in 2011, The Atlantic (Sept. 21, 2011), http://www.theatlantic.com/business/archive/2011/09/buffett-rule-rorschach-7-000-millionaires-paid-no-income-taxes-in-2011/245469/ (indicating that items such as tax exempt bonds and casualty losses account for the zero liability returns, citing Roberton Williams of the TPC).
High income investors face lower marginal rates than moderate income wage earners despite the AMT because the AMT applies preferentially low rates to investment income.

High income taxpayers can pay lower rates than moderate income taxpayers because preferential low rates apply to investment income under both the regular tax system and the AMT. In general, the AMT regime taxes upper-income taxpayers at a flat rate of 28 percent. Before 1997, capital gains were considered a preference item and taxed at the same flat rate as other AMT income. Under current law, however, long-term capital gains and qualified dividend income are subject to a special low rate, which is generally 15 percent, under both the regular tax and the AMT. Therefore, taxpayers who have sufficient resources to live off investment income pay tax at 15 percent (or perhaps less if they have tax-exempt bond income) — less than the 25 percent marginal rate applicable to a single person who earns just $34,501 in taxable income from wages.

The AMT is complicated and burdensome.

Although the IRS has not measured the compliance costs arising from the AMT, it has estimated that taxpayers spent over 18 million hours in 2000 completing and filing AMT tax forms or determining whether they needed to do so — more than 12 hours for each person who actually paid the AMT. By comparison, the IRS estimates that it takes 22 hours, on average, to fill out the entire Form 1040, U.S. Individual Income Tax Return.

Tax software and preparers can reduce but not eliminate the burden of the AMT.

While computer software and tax preparers can reduce the complexity of computing the AMT, significant burdens remain. For example, the amount of state and local tax refunds included in income depends on the extent to which the AMT limited the state and local tax deductions in the prior year. That amount often needs to be calculated manually because it requires the taxpayer to recalculate his or her prior-year income tax liability.

13 The 28 percent rate applies after a phase-out of the exemption amount and a 26 percent rate that applies to the first $175,000 of income. See generally IRC § 55.
14 Taxpayer Relief Act of 1997, Pub. L. 105-34, § 311(b), 111 Stat. 788 (1997) (reducing the rate applicable to long-term capital gains under both the regular tax system and the AMT).
15 Middle-income taxpayers who benefit from the AMT exemption face a higher marginal tax rate on long-term capital gains and dividend income because it decreases the value of the AMT exemption. See, e.g., Benjamin H. Harris and Christopher Geissler, Tax Rates on Capital Gains and Dividends Under the AMT, 118 Tax Notes 1031 (Mar. 3, 2008). An IRS analysis of the 400 taxpayers reporting the highest income found that between year 2000 and 2009, 46 to 72 percent of the income they reported was from capital gains. See IRS, SOI, The 400 Individual Income Tax Returns Reporting the Largest Adjusted Gross Incomes Each Year, 1992-2009 (2009), http://www.irs.gov/pub/irs-soi/09intop400.pdf.
17 Allen H. Lerman and Peter S. Lee, Evaluating the Ability of the Individual Taxpayer Burden Model To Measure Components of Taxpayer Burden: The Alternative Minimum Tax as a Case Study, 2004 IRS Research Conference 140, 151, 166 (Feb. 2005), http://www.irs.gov/uac/SOI-Tax-Stats—Papers—2004-IRS-Research-Conference (estimating the AMT added 18.4 million hours in burden (including burden for those who did not owe AMT), and that between 1.4 and 1.5 million taxpayers actually paid AMT or had a reduced credit in tax year (TY) 2000).
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One study found that between 62 and 67 percent of the Forms 6251, *Alternative Minimum Tax – Individuals*, received by the IRS in TY 2000 were unnecessary.\(^{19}\) Given the prevalent use of tax preparation software and tax preparers, this data suggests that such preparation aids do not always ease the complexity and burden of the AMT, even for taxpayers who are not subject to it. Moreover, this burden is growing as increasing numbers of taxpayers fall under the AMT regime — or at least believe they do.

**The AMT hides the true cost of tax cuts, as estimates of AMT revenue have proven illusory.**

The AMT replaces personal exemptions and some deductions (including the standard deduction and the deduction for state and local taxes)\(^{20}\) with an AMT exemption, and then applies its own rate schedule, which contains a marriage penalty. It may also limit the use of personal credits.\(^{21}\)

In this way, the AMT reclaims tax cuts and preferences enacted under the regular tax system, stealthily reducing their apparent cost. As a result, the AMT is projected to raise an enormous amount of revenue — about $1.2 trillion from 2011-2022 ($2.3 trillion if the 2001-2003 tax cuts are extended) according to one estimate, at least on paper.\(^{22}\)

In reality, the AMT is projected to have raised only about $33 billion in each of the last two years (2010 and 2011), which is the most it has ever raised.\(^{23}\) It does not meet revenue projections because Congress has repeatedly enacted short-term “patches” — eight since 2001 — to increase the AMT exemption amounts, sometimes on a retroactive basis.\(^{24}\)

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\(^{19}\) See Allen Lerman and Peter Lee, *Evaluating the Ability of the Individual Taxpayer Burden Model to Measure Components of Taxpayer Burden: The Alternative Minimum Tax as a Case Study*, 2004 IRS Research Conference 140, 151 fig. 5 (Feb. 2005), http://www.irs.gov/pub/irs-soi/04lerman.pdf (showing three different estimates for TY 2000 filings: 3.786 million / 5.657 million (or 67 percent), 3.104 million / 5.034 million (or 62 percent), and 2.923 million / 4.724 million (or 62 percent)). A study of TY 2000 returns indicated that 3.8 million taxpayers spent $331.8 million to file Form 6251 when it was not needed. Id. at 155 fig. 6, 162 fig.11.


\(^{21}\) For taxable years after 1999, nonrefundable personal credits generally may not offset the AMT. IRC §26(a)(1). However, for taxable years beginning in 2000 through 2011, nonrefundable personal credits are allowed to offset both regular tax liability and AMT liability. IRC §26(a)(2). Thus, the AMT could limit personal credits if they are not addressed in subsequent legislation.


The AMT significantly alters long-term federal deficit projections. More than half of the $1 trillion projected to be generated by the AMT over the next ten years (under current law) will not be collected if AMT patches continue to be enacted, which is likely to be the case absent fundamental tax reform.26

Temporary AMT patches prompt late-year and retroactive tax law changes.

AMT patches are necessary to keep middle class taxpayers from being hit by the AMT. In 2012, if Congress does not enact another retroactive patch, 46 percent of all tax filers with income between $75,000 and $100,000 will pay the AMT, as will 97 percent of those with income between $200,000 and $500,000.27 Yet, only 37 percent of millionaires will pay the AMT, as shown in the following chart.28

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25 TPC, Aggregate AMT Projections and Recent History, 1970-2022, (June 3, 2011), http://www.taxpolicycenter.org/numbers/displayatab.cfm?Docid=3511&DocTypeID=7. The revenue estimates include revenue from direct AMT liability on Form 6251, lost credits, and reduced deductions. Id. The estimates of the number of taxpayers affected by the AMT include those affected by each of these items. Id. They assume that if an AMT patch is enacted for 2012, all the temporary provisions in place for calendar year 2011 are also extended, with the exception of the payroll tax cut. They also assume the AMT patch sets exemption levels to those specified in Senate bill S.3413 for 2012 and 2013, indexes the 2013 levels in later years, and allows non-refundable personal credits against AMT liability. Senate bill S. 3413 sets the AMT exemption amount for 2012 at $50,600 for individuals and $78,750 for married taxpayers filing jointly and for 2013 at $51,150 for individuals and $79,850 for married taxpayers filing jointly. S. 3413, 112th Cong. (2012).

26 TPC, Aggregate AMT Projections and Recent History, 1970-2022 (June 3, 2011). JCT recently estimated that it would cost about $855 billion over 10 years to enact the President’s proposal to make the 2011 exemption amounts permanent, index them for inflation, index the 28 percent AMT bracket, and remove certain personal credits from the AMT. Congressional Budget Office (CBO), An Analysis of the President’s 2013 Budget 7 (Mar. 2012), http://www.cbo.gov/publication/43083 (citing a JCT estimate). A recent proposal to extend the AMT patch for 2010 and 2011 was estimated to cost about $136.7 billion if the Bush-era tax cuts were also extended. See JCT, JCX-54-10, Estimated Budget Effects of the “Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010,” Scheduled for Consideration by the United States Senate (Dec. 10, 2010), http://www.jct.gov/publications.html?func=startdown&id=3715.


Temporary or retroactive AMT patches appear less expensive than a permanent fix, but they add instability to the tax law, which causes problems for taxpayers and the IRS.29 These retroactive changes can make it difficult for the IRS to timely publish accurate forms and program its systems to process early tax filings — sometimes delaying urgently needed refunds.31 The IRS recently announced that it assumes Congress will pass an AMT patch before the end of 2012, so that Congress’ failure to pass a patch would cause delays.32 Congress’ failure to do so could affect 80 to 100 million taxpayers — more than half of all filers - potentially delaying their refunds.33

29 Id. Dependents are excluded from the analysis. Taxpayers are defined as returns with positive income tax liability net of refundable credits. We use the term “paying” AMT to include paying AMT liability on Form 6251, as well as any reduction of credits or deductions. The TPC’s estimates are based on a broad measure of income called “cash income,” defined as adjusted gross income minus taxable state and local tax refunds, plus total deductions from AGI, non-taxable pension income, tax-exempt interest, non-taxable social security benefits, cash transfers, worker’s compensation, employee’s contribution to tax deferred retirement savings plans, employer’s share of payroll taxes and corporate tax liability. Id. These projections assume that if an AMT patch is enacted for 2012 (i.e., current policy), all the temporary provisions in place for calendar year 2011 are also extended, with the exception of the payroll tax cut. The projections for the AMT patch adopt the AMT patch specified in Senate bill S.3413, which sets the AMT exemption amount for 2012 at $50,600 for individuals and $78,750 for married taxpayers filing jointly.

30 As noted above, JCT recently estimated the cost of a permanent fix would be $855 billion over 10 years, but a two-year patch (for 2010 and 2011) would be $136.7 billion. CBO, An Analysis of the President’s 2013 Budget 7 (Mar. 2012) (citing a JCT estimate for a permanent fix); JCT, JCX-54-10, Estimated Budget Effects of the “Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010,” Scheduled for Consideration by the United States Senate (Dec. 10, 2010) (AMT patch).

31 See, e.g., National Taxpayer Advocate 2007 Annual Report to Congress 3-12 (Most Serious Problem: The Impact of Late-Year Tax-Law Changes on Taxpayers).

32 Letter from Acting IRS Commissioner to Ranking Member, House Committee on Ways and Means (Nov. 13, 2012); Letter from Acting IRS Commissioner to Chairman, House Committee on Ways and Means (Dec. 19, 2012).

33 Id. This figure exceeds the number subject to the AMT because (1) the patch generally includes tax credit ordering rules, which affect many taxpayers who are not subject to AMT, (2) the IRS would not be able to process certain forms and schedules from anyone, and (3) the IRS would not be able to process returns from anyone whose income level might subject them to the AMT. Id.
The AMT causes estimated tax underpayments, reducing tax compliance and increasing taxpayer burden.

Frequent AMT patches combine with the inherent complexity of the AMT to make it nearly impossible for taxpayers to estimate their tax liabilities in advance. The AMT is so complicated that the IRS’s wage withholding calculator does not even consider the AMT in determining how much taxpayers should withhold. Many taxpayers first learn they are subject to the AMT only after preparing their returns, when it is too late to increase their withholding or estimated tax payments. Taxpayers who did not withhold or pay enough estimated tax are subject to penalties. While we cannot determine how many taxpayers were subject to estimated tax penalties solely because of the AMT, IRS data shows that for tax year 2011, about 17 percent of those subject to the AMT were liable for estimated tax penalties, as compared to 4 percent of individual taxpayers overall. Some taxpayers will not be able to afford to pay their tax (or penalties) in one lump sum at the end of the year. Thus, the unpredictability of the AMT likely reduces voluntary compliance.

The AMT hinders informed debate about tax reform options.

The constantly-shifting AMT rules make it more difficult for the government to estimate its revenues and the actual cost of changes to the regular tax system. For example, extending the 2001-2010 individual income tax cuts may appear less costly because the AMT is projected to recoup nearly one quarter of those cuts. At the same time, the cost of repealing the AMT may be exaggerated if estimators assume temporary tax cuts will be extended and that the AMT will generate revenue by negating those cuts. Notably, ten-year estimates of AMT revenue double (from $1.05 trillion to $2.19 trillion) if expiring tax cuts are extended. As a result, the AMT makes it more difficult for the public to understand the true costs of fundamental tax reform.

Temporary AMT patches compound these difficulties. The bipartisan 2005 Tax Reform Panel observed, “a tax reform proposal that does not repeal the AMT effectively results in

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34 The calculator refers taxpayers to Publication 919. See IRS Withholding Calculator (Jan. 25, 2012), http://www.irs.gov/individuals/article/0,,id=96196,00.html (“CAUTION: If you will be subject to alternative minimum tax, self-employment tax, or other taxes; you will probably achieve more accurate withholding by following the instructions in Publication 919, How Do I Adjust My Tax Withholding?”). Publication 919 instructs taxpayers to project their AMT liability by filling out Form 6251 or the Alternative Minimum Tax Worksheet in the Form 1040A instructions, a daunting task that few are likely to undertake before the end of the year, especially if they believe the law might change on a retroactive basis.

35 IRS Compliance Data Warehouse Individual Returns Transaction File and Individual Master File (Tax Year 2011). The National Taxpayer Advocate has recommended legislation to waive the estimated tax penalty for those who pay at least 100 percent of the amount due for the prior year, are subject to a de minimis penalty, or are first-time estimated taxpayers and have reasonable cause for the violation. National Taxpayer Advocate 2008 Annual Report to Congress vol. 2, 30-35.

36 Studies suggest that unexpected tax liabilities reduce filing, payment, and reporting compliance. See National Taxpayer Advocate 2008 Annual Report to Congress vol. 2, at 30-35 (summarizing various studies).


a hidden, but real, future tax hike." They may have been referring to the AMT patches, which are always scheduled to expire, essentially triggering a future tax hike. As noted above, the largest components of that tax hike involve eliminating the standard deduction and the deduction for state and local taxes, and imposing marriage penalties. If Congress wanted to raise taxes in this manner, it could do so under the regular tax system. The merits of such a tax hike could easily be compared to alternative proposals for reform.

As the system is now structured, however, proponents of serious tax reform have to compare the cost of their proposals to current law, which includes a hidden tax increase because the AMT patch is always scheduled to expire. Alternative proposals that repeal the AMT may seem unduly expensive by comparison, even if the public would not accept and Congress would not adopt the hidden AMT tax increase that exists under the current law system of patches. As a result, it may be more difficult for the public to evaluate the true merit of realistic tax reform alternatives.

CONCLUSION

The National Taxpayer Advocate first recommended repeal of the AMT in the Annual Report to Congress for 2001 and has advocated for its repeal consistently over the past decade. We reiterate this recommendation.

In 1999, Congress voted to repeal the individual AMT, but the legislation was vetoed. The American Bar Association Section of Taxation, the American Institute of Certified Public Accountants Tax Division, and the Tax Executives Institute have jointly called for the repeal of the AMT. The National Association of Enrolled Agents also advocated outright repeal or substantial restructuring of the AMT for individuals. Similarly, both the 2005 Tax Reform Panel and the 2010 National Commission on Fiscal Responsibility and Reform (the Simpson-Bowles Commission) recommended repealing the AMT. Leaders of both parties

41 See, e.g., sources cited supra note 2.
43 American Bar Association Section of Taxation, American Institute of Certified Public Accountants Tax Division & Tax Executives Institute, Tax Simplification Recommendations, reprinted at 2000 TNT 39-82 (Feb. 28, 2000).
in both the House and Senate have also recently proposed repealing it. For all of the reasons stated above, the National Taxpayer Advocate continues to recommend permanent repeal of the individual AMT.