# THE ALTERNATIVE MINIMUM TAX: AN ILLUSION OF FAIRNESS

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***ABSTRACT***

*Representatives in Washington, D.C. have expressed an interest in addressing the alternative minimum tax (AMT). Many have verbalized their concern with the so-called "stealth tax." An understanding of the stealth nature of this onerous and daunting tax is imperative to curbing its effects on the unsuspecting middle class.*

*The AMT is a separate method of determining income tax devised to ensure that at least a minimum amount of tax is paid by high-income corporate and individual taxpayers who reap large tax savings by making use of certain deductions. The objective of the tax is to recapture tax reductions resulting from the use of special tax relief provisions of the tax law. However, in recent years, the AMT has ensnared more and more average taxpayers in its ever- expanding web.*

*Annual "patches" legislated by Congress have failed to provide the relief necessary to free middle class taxpayers from its grip. A full repeal of the AMT is estimated to cost at least $800 billion over ten years. Many of the loopholes in existence when the AMT was originally enacted have since been closed. Congress should fully repeal the AMT and look to other revenue raisers to replace any anticipated lost revenue. Alternatively, this parallel tax system should undergo a major overhaul.*

## INTRODUCTION

Representatives in Washington, D.C. have expressed an interest in addressing the alternative minimum tax (AMT). Many have verbalized their concern with the so-called "stealth tax." In September 2007 the House Ways and Means Committee recognized that Congress was obliged to tackle the unintended consequences of the AMT and pledged a solution by "simplifying the tax code" and instilling a greater "sense of fairness" in the system (LexisNexis, 2007). Most recently, in connection with the "debt ceiling" debate, there has even been discussion of a possible repeal of the AMT. An understanding of the stealth nature of this onerous and daunting tax is imperative to curbing its effects on the unsuspecting middle class.

The tax law historically has included incentives intended to encourage economic and social behavior of taxpayers, For example, the favorable treatment allowed research and development expenditures is intended to foster technological progress. Deductions allowed for donations to charitable organizations encourage charitable giving. Some taxpayers have been able to take advantage of a considerable amount of these incentives to avoid or minimize federal taxes. Although their taxes were being reduced legally, Congress was concerned that taxpayers with substantial income can avoid paying taxes.

## BACKGROUND

The AMT is a separate method of determining income tax devised to ensure that at least a minimum amount of tax is paid by high-income corporate and individual taxpayers who reap large tax savings by making use of certain deductions, exemptions, losses and credits (CCH, 2010). The objective of the tax is to recapture tax reductions resulting from the use of special tax relief provisions of the tax law (Smith, 2011).

The minimum tax was enacted into law in 1969 after Congress learned that 155 taxpayers with adjusted gross income of $200,000 or more for the 1966 tax year had paid no federal income taxes (IRS, 2003). It was originally a populist measure aimed at forcing wealthy families who used tax shelters and certain deductions to avoid paying income tax. Whereas approximately 20,000 taxpayers were subject to the AMT in its first year, 1970, that amount is expected to exceed 43 million taxpayers by 2018, according to the Urban Institute and Brookings Institution (Burman, Koch, Leiserson and Rohaly, 2008).

At first, the AMT imposed a ten percent add-on tax when the sum of eight main tax preference items (TPI) exceeded $30,000. The eight TPI's were: excess investment interest income, accelerated depreciation on personal property, accelerated depreciation on real property, amortization of certified pollution control facilities, amortization of railroad rolling stock, tax benefits from stock options, bad debt deductions of financial institutions, and capital gains deductions. In 1976, Congress increased the add-on tax from 10 percent to 15 percent and the threshold for triggering the add-on was reduced from $30,000 to $10,000. In 1982 Congress repealed the 15 percent add-on and passed the "Tax Equity and Fiscal Responsibility Act of 1982." The AMT provisions enacted in 1982 are the foundation of the present-law AMT. At that time the deduction for state and local taxes, personal exemptions, the standard deduction and the deduction for interest on home equity loans was not allowed in computing the AMTI. The gain on incentive stock options was includible in AMTI (JCX, 2005). That law changed the AMT from an add-on tax to its current form as a parallel tax system. The new tax structure sought to satisfy the original policy goal which was to eliminate tax shelters for the rich. However, with the elimination of the add-on tax, ***all*** taxpayers are required to calculate a separate tax, aimed not at exotic tax shelters used by a minority of wealthy taxpayers but instead, aimed at people who own homes, live in high tax states and have children (Wikipedia, 2011).

## THE PROBLEM

The AMT is a tax system that is parallel to the regular income tax. It was originally designed to capture a small number of wealthy taxpayers who were avoiding taxes, but the AMT's reach has ballooned in recent years. The AMT primarily affects middle- to upper-middle income taxpayers.

Low income taxpayers are largely unaffected by the AMT because of the exemption amount, while the wealthiest taxpayers are generally unaffected because they are already subject to the highest tax rates under the regular income tax system. Middle- and upper-middle income taxpayers are most at risk in the coming years. According to Congressional Budget Office (CBO) estimates, taxpayers earning between $50,000-$200,000 will be the hardest hit by the AMT in coming years, especially those in high cost of living areas with high per-capita incomes and high state and local taxes (Shakin, 2010).

For most of its existence, the AMT has played a minor role in the tax system, accounting for less than two percent of individual income tax revenues and affecting less than one percent of taxpayers in any year before 2000. Since then the tax would have reached more and more taxpayers but for Congressional intervention in the form of "patches." In spite of these temporary adjustments (patches) and because of the particular tax preferences and exemptions disallowed under the AMT, it is more likely to affect married couples, large families and taxpayers with high state and local taxes (Shakin, 2010). Inflation is the most important driver of long-term growth in receipts from the AMT. Under the regular individual income tax, the tax rate brackets, exemptions and certain deductions and credits are adjusted automatically to keep pace with inflation. However, the exemption amounts and rate brackets used to calculate the AMT are not indexed. If income grows at the rate of inflation, regular tax liability also rises with inflation, but AMT liability grows faster because income is rising but the AMT's exemption amounts and rate brackets are not. The CBO estimates that if current law remains in effect, the AMT would affect more than 30 percent of taxpayers in 2030 and 60 percent by 2050 (Shakin, 2010).

## PROBLEM REACH

As the impact of the AMT expands, it will increasingly affect taxpayers in lower income groups than has historically been the case. Many taxpayers previously subject to the AMT were the relatively small group of higher income filers who itemized deductions and used tax preferences that were available but disallowed under the alternative tax. We have already begun to see a shift whereas taxpayers with lower income have become subject to the AMT because it disallows the personal exemption (which all taxpayers use) and the standard deduction (which about two-thirds of filers use). The biggest *change* is expected for taxpayers with income between $100,000 and $200,000. The share of those taxpayers with AMT liability is expected to rise from 17 percent in 2009 to 85 percent in 2010 (Shakin, 2010).

## HOW DOES THE AMT WORK?

The AMTI formula is as follows:

Taxable income
\+ positive AMT adjustments
\- negative AMT adjustments
\+ tax preferences
= Alternative Minimum Taxable Income (AMTI)

The purpose of the formula is to reconcile taxable income to AMTI. This reconciliation is accomplished by entering reconciling items to account for differences between regular income tax provisions and AMT provisions. The reconciling items are referred to as either AMT adjustments or tax preferences. Adjustments can be positive or negative, but preferences are always positive (Willis, 2010).

Some AMT adjustments are:

- Medical expenses
- State income tax or sales tax
- Property taxes
- Miscellaneous itemized deductions
- Interest from specified private activity bonds
- Incentive stock options
- Depreciation of post-1986 property
- Circulation expenditures
- Mining costs (IRS Form 6251)

Generally, if a *deduction* for regular income tax purposes exceeds the deduction allowed for AMT purposes, the difference is a positive adjustment and vice versa (increasing the taxable income in arriving at AMTI). If i*ncome* reported for regular tax purposes exceeds the income reported for AMT purposes, the difference is a negative adjustment and vice versa (reducing taxable income in arriving at AMTI). Note however, that income exclusions, such as the exempt income on private activity bonds, are positive adjustments in arriving at AMTI.

Some tax preferences are:

- Percentage depletion in excess of the property's adjusted basis
- Excess intangible drilling costs reduced by 65% of the net income from oil, gas and geothermal properties
- Interest on certain private activity bonds
- Excess deprecation on property placed in service before 1987

Preferences are items that are never allowed for AMT purposes and are therefore always positive adjustments in calculating AMTI. The conversion of AMTI to AMT involves the use of specified exemptions, rates and a credit. The exemption amount enables a taxpayer with a small amount of positive adjustments and tax preferences to avoid being subject to AMT. The exemption amount for **2011** is $74,450 for married filing jointly and surviving spouses, $48,450 for unmarried taxpayers and $37,225 for married taxpayers filing separately. The exemption is phased out at a rate of $0.25 on the dollar when AMTI exceeds:

$112,500 for single taxpayers
$150,000 for married taxpayers filing jointly
$75,000 for married taxpayers filing separately

These exemption reductions cannot reduce the exemption below zero (IRC Sec. 55(d)(3)). The phase-out of the exemption applies the wherewithal to pay concept. As income increases, so does ability to pay taxes.

The AMTI described above is the starting point for the AMT calculation:

Exhibit 1
AMT Calculation

| |
|---|
| AMTI |

| |
|---|
| Exemption amount (as adjusted for phase-out over threshold amount) |
| Net AMTI |
| Tax is applied as follows: 26% on first $175,000, then 28% on remainder (preserving the capital gains rate on qualified dividends and capital gains) |
| Subtract alternative minimum tax foreign tax credit |
| Tentative minimum tax |
| Regular tax |
| AMT = Tentative minimum tax > Regular tax |
| The tentative minimum tax is compared to the regular tax per the tax return. If the tentative minimum tax is greater than the regular tax, there is an AMT. If the tentative minimum tax is less than the regular tax, the AMT is zero.<br>Taxpayers pay the higher of the two, the tentative minimum tax or the regular tax. |

Exhibit 1 illustrates how the tax calculation employs the concept of "alternative minimum taxable income" which refers to the taxable income for the year determined with adjustments and increased by tax preference items. The AMTI is then reduced by an exemption amount to arrive at net alternative minimum taxable income. This net alternative minimum taxable income is multiplied first by 26% then 28% tax rate. That is, the first $175,000 of net AMTI is taxed at 26% with the excess being taxed at 28%. Dividends taxed at 15% for regular tax purposes are also taxed at that rate for AMT purposes. Long term capital gains taxed at 15% and 25% for regular tax purposes are also taxed at those rates for AMT purposes. The foreign tax credit and the nonrefundable personal credits are the only nonrefundable credits allowed against the tax in arriving at the tentative minimum tax. The AMT is the difference between the regular tax (reduced by nonrefundable credits) and the tentative minimum tax (Smith, 2011).

<u>AMT Illustration</u>

In *2010*, Ms. Adams, single, had a salary of $200,000, paid real estate taxes of $35,000 and state and local income tax of $15,000, resulting in a regular tax liability of $34,687 (taxable income = $200,000 salary - $35,000 real estate taxes - $15,000 state and local income taxes - $3,650 personal exemption = $146,350. Regular tax on $146,350 of taxable income for a single taxpayer is $34,687). The $50,000 real estate and income taxes are not deductible when computing the AMT. This will result in a tentative minimum tax of $45,351* and an AMT of $10,664 ($45,351 less $34,687). Ms. Adams must pay both the regular tax of $34,687 and the AMT of $10,664, or a total of $45,351.

Calculation of the Tentative Minimum Tax:

| | | |
|---|---|---|
| AMTI | $ 200,000 | ($146,350 + $3,650 (personal exemption) + $50,000 (total of real estate taxes and state and local income taxes)) |
| Exemption | -$ 25,575 | ($200,000 - $112,500 phase out amount for single taxpayer =87,500 excess *0.25= $21,875 exemption phased-out from $47,450) |
| | $ 174,425 | |
| Tax Rate | *0.26 | |
| | $45,351 | Tentative Minimum Tax |

The exemption phase out has been made equal for married taxpayers filing separately to those filing jointly. Married taxpayers filing separately, increase AMTI by the *lesser* of (1) 25% of the excess of AMTI over the applicable phase-out ceiling **or** (2) the applicable AMT exemption amount for the married filing separate category (Code Sec. 55(d)(3)). In **2011**, for instance, taxpayers filing separately whose AMTI exceeded $223,900 must do a special calculation. AMTI must be increased by the *lesser* of (1) 25% of the excess AMTI over $223,900 **or** (2) $37,225.

Just as married persons filing separately are subject to an upper limit of $223,900, the analysis in Exhibit 2 of the levels at which the AMT exemption completely phases out provides some clarity for each filing status.

Exhibit 2
Exemption Phaseout

| Filing status | Calculation | AMT exemption phase out |
|---|---|---|
| Single & head of household | ($48,450 x 4) + $112,500 | $306,300 |
| Married filing jointly & qualifying widow/er | ($74,450 x 4) + $150,000 | $447,800 |
| Married filing separately | ($37,225 x 4) + $75,000 | $223,900 |

As previously mentioned, exemption amounts vary by filing status. A multiple of 4 is used in the calculations in Exhibit 2 because the *exemption* amount ($48,450, $74,450, or $37,225, respectively) is decreased by 25% of the amount that AMTI exceeds the *threshold* amount ($112,500 single and head of household, $150 000 married filing jointly, or $75,000 married filing separately). It should be noted that the married filing separate amounts are half of the married filing joint amounts.

## CREDIT RELIEF FOR THE PRIOR YEAR MINIMUM TAX

Internal Revenue Service (IRS) Form 8801 allows individuals, estates and trusts to figure the minimum tax credit for AMT incurred in prior years. The form is also used to figure the tax credit carryforward.

The AMT paid one year may be carried forward indefinitely as a credit against the regular tax liability. The credit may not be used to offset any future minimum tax liability. A taxpayer is not allowed to take a credit larger than the amount necessary to reduce the regular tax to the amount of the tentative minimum tax (CCH, 2010). Exhibit 3 illustrates how this would work:

Exhibit 3
Credit Carryforward

| Form 8801-Credit for prior year minimum tax – Part II – line # | |
|---|---|
| 16. prior year AMT | $15,673 |
| 22. this year's regular tax | $17,462 |
| 23. this year's tentative minimum tax | $ 9,833 |
| 24. line 22-line 23 : amount needed to reduce regular tax to tentative minimum | $ 7,629 |
| 25. minimum tax credit | $ 7,629 |
| 28. minimum tax credit carryforward | $ 8,044 ($15,673 – $7,629 from line 25) |

This taxpayer's regular tax of $17,462 in Exhibit 3 has been reduced by $7,629 this year. This is because the tentative minimum tax is less than the regular tax. A carryforward credit of $8,044 has the potential for reducing the regular tax in future years.

It should be noted that a taxpayer's minimum tax credit carryforward can conceivably be entirely used in one single tax year so long as the regular tax exceeds the tentative minimum tax by at least $1 more than the difference between these. To illustrate, consider the information shown in Exhibit 4.

Exhibit 4
Credit Consumption

| Form 8801-Credit for prior year minimum tax – Part II – line # | |
|---|---|
| 16. prior year AMT | $ 56 |
| 22. this year's regular tax | $20,068 |
| 23. this year's tentative minimum tax | $19,026 |
| 24. line 22-line 23 : amount needed to reduce regular tax to tentative minimum | $ 1,042 |
| 25. minimum tax credit | $ 56 (this is not more than last year's AMT in this particular case) |
| 28. minimum tax credit carryforward | $0 ($56 - $56 from line 25) |

On the other hand, a taxpayer can realistically see the carryforward credit slowly disappear year after year without ever deriving a benefit from it. This can happen when a net minimum tax on exclusion items exists in conjunction with an excess of regular tax over tentative minimum tax (recall this triggers an AMT). The net minimum tax on exclusion items is the excess of tentative minimum tax on exclusion items over the regular tax. The calculation of the tentative minimum tax on exclusion items involves a calculation similar to that employed in arriving at AMTI, but is beyond the scope of this article. Nonetheless, a look at Exhibit 5 illustrates how this net minimum tax can slowly consume the carryforward credit without a benefit to the taxpayer.

Exhibit 5
Diminution of Credit Carryforward

| Form 8801-Credit for prior year minimum tax – Part II – line # | |
|---|---|
| 16. prior year AMT | $106,015 |
| 17. net minimum tax on exclusion items | $ 4,314 |
| 22. this year's regular tax | $ 94,929 |
| 23. this year's tentative minimum tax | $105,618 |
| 24. line 22-line 23 : amount needed to reduce regular tax to tentative minimum | $0 |
| 25. minimum tax credit | $0 |
| 28. minimum tax credit carryforward | $101,701 ($106,015 - $4,314) |

Generally, taxpayers in higher income brackets will fall prey to this situation. The minimum tax credit on line 25 works against these taxpayers in a two-staged approach. First, because there is a net minimum tax on exclusion items this year, it works to reduce the prior year AMT that will be available for carryover credit to $101,701 from $106,015 for our taxpayer in Exhibit 5. Second, the amount on line 24 is zero because the tentative minimum tax ($105,618) exceeds the regular tax ($94,929). The taxpayer is subject to an AMT because tentative minimum tax exceeds regular tax. Consequently, there is no opportunity for utilizing any of the carryforward credit. Recall that the carryforward credit helps to reduce the regular tax, but *only when there is no AMT*. In years when there is an AMT, the taxpayer does not see the credit carryforward utilized. The carryforward credit is slowly reduced by the net minimum tax on exclusion items, with the taxpayer never reaping the benefit of the credit carryforward.

## THE IMPACT OF INCREASING EXEMPTION AMOUNTS

Increasing the amount of the AMT exemption has the intended impact of gradually factoring out taxpayers who would otherwise be subject to the tax. This is accomplished by lowering the amount of income subject to the AMT rates of 26% and 28%. The result is a lower tentative minimum tax before alternative minimum tax foreign tax credit, which is then compared to the regular tax. If the tentative minimum tax is less than the regular tax, there would be no AMT.

Here's how increasing the exemption amount provides relief for certain taxpayers who might be subject to the AMT:

Exhibit 6
Impact of Increasing Exemptions Amounts

| | 2005 | 2007 | 2010 |
|---|---|---|---|
| Exemption worksheet line # | | | |
| 1. **exemption amount** | $40,250 | $44,350 | $48,450 |
| 2. AMTI | $113,251 | $113,251 | $113,251 |
| 3. phaseout amt | $112,500 | $112,500 | $112,500 |
| 4. subtract lines 2-3 (excess of AMTI over phaseout) | $ 751 | $ 751 | $ 751 |
| 5. 25% of line 4 | $ 188 | $ 188 | $ 188 |
| 6. exemption as adjusted | $40,062 | $44,162 | $48,262 |
| | | | |
| Form 6251 line # | | | |
| 29. exemption as adjusted | $40,062 | $44,162 | $48,262 |
| 30. income subject to AMT (AMTI – adjusted exemption) | $73,189 ($113,251 - $40,062) | $69,089 ($113,251 - $44,162) | $64,989 ($113,251 - $48,262) |
| 31. AMT rates: 26% up to 175k (26% x line 30) | $19,029 (.26 x $73,189) | $17,963 (.26 x $69,089) | $16,897 (.26 x $64,989) |

The amount on line 31 of Exhibit 6 shows what the tentative minimum tax would be if alternative minimum tax foreign tax credit is zero. Each of the succeeding years illustrated above shows a lower amount on line 31. The significance of a lower amount on line 31 is that with a lower tentative minimum tax, the only way a taxpayer would be subject to the AMT is if this tentative tax is higher than the regular tax. The likelihood of the tentative tax being higher is greater under the 2005 scenario, where the adjusted exemption amount is lower.

## THE IMPACT OF INCREASING EXEMPTION PHASE-OUTS

Besides increasing the exemption amount, another way to provide tax relief would be to increase the threshold amount from $112,500. An increase in the threshold amount would lower the phase-out amount used to lower the exemption amount. See how this would work in Exhibit 7 below.

Exhibit 7
Impact of Increasing Phaseout Amounts

| Exemption W/S line # | Threshold amount | Increased threshold |
|---|---|---|
| 1. exemption amount | $48,450 | $48,450 |
| 2. AMTI | $116,533 | $116,533 |
| 3. **phase-out amt** | $112,500 | $150,000 |
| 4. subtract lines 2-3 | $ 4,033 | -0- |
| 5. 25% of line 4 | $ 1,008 | -0- |
| 6. exemption as adjusted | $47,442 ($48,450 - $1,008) | $48,450 ($48,450 - $0) |

An increase in the phase-out amount (to say $150,000 from $112,500) results in a higher adjusted exemption ($48,450 as compared to $47,442). The greater the adjusted exemption amount, the lower the net AMTI amount. The net AMTI amount is the amount upon which the tentative minimum tax is being calculated, as illustrated in the previous table. The smaller the net AMTI amount, the lower the tentative minimum tax. A lower tentative minimum tax has a greater chance of being smaller than the regular tax, resulting in zero AMT.

## WHAT ARE OUR OPTIONS?

Complete elimination of the AMT may result in taxpayers with the ability to pay having an escape from taxation. The table below shows how, without the AMT, one can conceivably escape taxation. One option would be to completely repeal the AMT while another would be to modify the current structure.

Exhibit 8
Impact of Changes in AMT Adjustments using year 2011 amounts

| Form 6251 line # | Current system | Current exemption | Lower exemption |
|---|---|---|---|
| 1. TI before dependency exemption | $3,700 | Allow dependency exemption | Allow dependency exemption |
| 3. SALT | $100,000 | $85,000 | $85,000 |
| 28. AMTI | $103,700 | $85,000 | $85,000 |
| 29. exemption | $48,450 | $48,350 | $38,350 |
| 30. subtract | $55,250 | $36,650 | $46,650 |
| 31. 26% line 30 | $14,365 | $9,529 | $12,129 |
| 33. tentative minimum | $14,365 | $9,529 | $12,129 |
| 34. regular tax | $0 | -0- | -0- |
| 35. AMT | $14,365 | $9,529 | $12,129 |

Exhibit 8 above illustrates a single taxpayer with AGI of $103,700, personal exemption of $3,700, and real estate taxes of $100,000. Given the deductibility of the real estate taxes, the taxpayer would have no taxable income. The same individual without the real estate tax deduction would have taxable income of $94,200 (AGI $103,700 less personal exemption of $3,700 and standard deduction of $5,800) and pay taxes in the amount of $19,993. The current

AMT system guarantees that the taxpayer who wipes out taxable income as shown in the above exhibit, would at least pay an alternative minimum tax.

The last two columns of Exhibit 8 show the AMT with different levels of exemptions. Exemptions should continue to be raised in conjunction with changes made to make the system fairer for the average taxpayer. Our same single taxpayer with $100,000 in real estate taxes would pay $0 regular tax, but an AMT of $9,529 if forced to add back $85,000 ($100,000 less $15,000 allowed) of the $100,000 in real estate taxes as proposed above. In the third column of Exhibit 8 we see that a reduced exemption amount (line 29) from $48,350 to $38,350 results in an AMT which is $2,600 ($12,129-$9,529) greater than when the exemption amount was $10,000 more. Reducing exemption amounts is contrary to the spirit of providing relief from the AMT and is not recommended. Indeed exemption amounts should continue to be increased, but at a greater pace than the typical “patches” enacted in recent years.

With many middle income taxpayers getting caught in the AMT trap, it would appear fair to make adjustments to the current system. First, personal exemptions should be allowed as deductions in arriving at AMTI. In recent years, these have become more documentable through the cooperative efforts of the IRS and Social Security Administration. Secondly, a taxpayer with real estate taxes amounting to $100,000 indeed has either wherewithal to pay or is living far beyond his/her means. The people of the U.S. should not be asked to underwrite such excesses. The regular tax deduction for real estate taxes should be allowed as these taxes help pay for educating society. There is indeed a social good that comes with payment of real estate taxes because real estate taxes help finance public education. For AMT purposes, an add back adjustment for real estate taxes exceeding, for instance, $15,000 might be considered fair to the average taxpayer, without subsidizing excesses. Third, state income taxes are a documentable deduction and should not be a positive adjustment in arriving at AMTI. State taxes are already a burden, and a modification allowing a deduction for state and local income taxes would provide relief for taxpayers in states with high income taxes. Fourth, another source of abuse, as the IRS itself has found, is charitable donations. Charitable deductions should be limited to a percentage of income, with an add-back adjustment for charitable donations in excess. Unlike mortgage interest, the deduction for charitable donations is only substantiated upon audit and leaves continued room for abuse.

In his report to the CBO, Williams (2004) estimated that permitting the personal and dependency exemption would eliminate the AMT impact for about 6 million units in 2010. Allowing taxpayers to deduct state and local taxes for AMT purposes would eliminate the AMT impact for approximately 10 million units, or about one-third of those who would otherwise pay the AMT. Combining these two options, and allowing the deduction for both the personal and dependency exemptions as well as state and local taxes, would move about 18 million taxpayers off the AMT rolls. Another study by Steuerle (2011) advocates reforming the deductions allowed for charitable giving.

Another recommendation for modifying the AMT relates to incentive stock options (ISOs). The inclusion of the bargain element for ISOs represents a contradiction of the wherewithal to pay concept. Taxpayers subject to the AMT due to stock options that are not immediately turned into cash clearly are cash poor. The exercise of stock options has generated nothing more than a paper gain. Its inclusion as a source of income for AMT purposes is clearly questionable. This is indeed an AMT adjustment without justification. There is never a guarantee that the price of the stock will increase. In fact, when the sale of the stock results in a loss, courts have denied the full amount of the loss for AMTI purposes. Yet the full amount of the paper gain was used to determine AMT paid in the year the exercised shares are freely transferable or are not subject to any substantive risk of forfeiture, and not necessarily, when the shares are actually sold. Critics of the AMT argue that various features of the tax are flaws, including taxes owed in the year that an exercise of ISO stock occurs, even if no stock is sold. Although no actual income exists, the bargain element of the exercise is considered income under the AMT system.

## ARGUMENTS FOR AND AGAINST REPEAL

While some argue that the AMT could be amended so as to have little or no effect on those with lower income, the main thrust of the arguments against its repeal revolve around the loss of revenue. The loss is expected to be between at least $800 billion over ten years (Aron-Dine, 2007).

Policy analysts are divided over the best way to address the criticisms of the AMT. Members of the Tax Policy Center, a joint program of the Urban Institute and Brookings Institution, have proposed a revenue neutral, highly progressive replacement for the AMT. They suggest an option that would repeal the AMT and replace it with an add-on tax of four percent of adjusted gross income above $100,000 for singles and $200,000 for couples. The thresholds would be indexed for inflation. The Cato Institute is among the groups calling for repeal of the AMT. Among the reasons it sites for its position of repeal are: many tax loopholes the AMT was designed to address have since been closed, the AMT is needlessly complex and burdensome to taxpayers and a full repeal would leave Federal revenues as a fraction of GDP at about 18% which is its average value in recent decades. The National Taxpayers Union also supports repeal saying that "it is wholly unfair for policymakers to promote certain social and fiscal ideas through exemptions, credits and deductions, only to take these incentives away (Wikipedia, 2011).

The individual AMT is a separate tax system within the individual income tax system. As such, it should be analyzed in terms of equity, efficiency and simplicity (JCX, 2005). To assess whether the AMT promotes the overall equity of the tax system, it is necessary to look to who bears the burden of the tax. The AMT imposes a marginal tax rate on income that differs from tax rate under the regular income tax. The AMT also raises equity issues with respect to preference items that are personal in nature. For example, some believe that it is fair that families with multiple dependents pay less tax than families with fewer dependents. This notion is supported by the regular tax allowance of personal exemptions. In disallowing these exemptions, however, the AMT may frustrate this view of fairness (JCX, 2005).

A tax system is efficient if it does not distort the choices that would be made in the absence of the tax system. Conventional wisdom holds that in measuring economic income, deductions should be allowed for expenses incurred in the production of income. But the AMT disallows the deduction for miscellaneous itemized deductions, including those for unreimbursed employee business expenses and investment expenses that relate to the production of income. Disallowing such deductions may lead to inefficiencies as taxpayers may be discouraged from certain otherwise profitable investments or activities or encouraged to rearrange their affairs to secure

AMT deductions for such costs (moving such deductions “above the line”). As an income tax, the AMT reduces the after-tax compensation from working and saving. Thus, the AMT may distort decisions to supply labor and capital. The degree of additional distortion created by the AMT depends on the rates of the AMT compared to those of the regular tax. No tax can be fully efficient, and thus the efficiency of the AMT is best judged against the regular income tax. The AMT adds complexity because it requires a calculation of a second income tax base and computation of tax on that base. This exercise itself imposes a burden on taxpayers. A tax system should not be so complex as to require the use of software or paid return preparers to prepare tax returns (JCX, 2005).

Noteworthy is the IRS’s National Taxpayer Advocate report dated December 31, 2003. Nina Olson, National Taxpayer Advocate, in her annual report to Congress identified the AMT as the most serious problem facing taxpayers. She noted then that although the AMT was originally enacted to prevent wealthy taxpayers from avoiding tax liability through the use of tax avoidance techniques, it affected a substantial number of middle-income taxpayers and by 2010 would affect more than 30 million taxpayers. Ms. Olson recommended that Congress repeal the AMT, or at least make changes to lessen its impact on middle-income taxpayers (IRS, 2003). Again, in her 2006 annual report to Congress, Ms. Olson advocates repeal of the AMT, calling it the “poster child for tax-law complexity.” She notes that most of the significant tax loopholes that enabled taxpayers to escape tax at the time the AMT legislation was passed have since been closed. It now affects large groups of taxpayers with no tax-avoidance motives at all. Additionally, the complexity of the AMT leads to most taxpayers who owe AMT not realizing it until preparing their returns, causing many to be subject to a penalty for failure to pay sufficient estimated tax (IRS, 2006). Ms. Olson has repeatedly recommended repeal of the AMT, including in her 2001, 2004 (IRS, 2006) and 2008 (IRS, 2008) reports. Most recently, President Obama’s own National Commission on Fiscal Responsibility and Reform advocated in its report that the alternative minimum tax be repealed (2010).

## CONCLUSIONS AND RECOMMENDATIONS

The “pay-as-you-go” budget rules require that revenue raisers be adopted to offset the cost of revenue losing tax provisions. The AMT has imposed a burdensome tax, often on those who can ill afford it. As the AMT increasingly strikes the middle class, this group is burdened with a tax that is an added hardship in already difficult times. The once proposed increase in the income tax rates on hedge fund profits would tax profits or gains at ordinary rates. The profit on the “carried interest,” the profit hedge fund managers receive, represents cash on which the taxpayer has an ability to pay tax at a rate greater than 15%. On September 6, 2007 the Senate Finance Committee (2007) heard presentations on the impact on investors of increasing the tax rate on the carried interest income earned by partners in private equity groups and hedge funds. Our representatives in Washington, D.C. should consider offsets such as an increase in the hedge fund profits tax, to pay for what is an unjustifiable tax on the middle class. Carried interest is estimated to generate $18 billion in tax revenue (Senate Finance Committee, 2007).

Many of the potential revenue offsets that would help pay for repeal or significant modification of the AMT can be found in The President’s deficit reduction plan released in September (2011). However, many more revenue offsets can be found, starting with closing the tax gap. In her 2006 report to Congress, Nina Olson, the National Taxpayer Advocate (IRS, 2006) indicated that the “tax gap” was among the most serious problems facing tax administration. At that time, the gap was $290 billion of tax revenue that the government failed to collect each year. Today the gap is $345 billion. With 130 million tax returns filed, this failure to collect tax revenue translated to more than $2,200 ($290 billion/130 million tax returns) of additional taxes being assessed on compliant taxpayers to subsidize noncompliance by others. At the time, the Advocate proposed three broad strategies to help combat the problem. Today, the IRS is moving closer to addressing this issue, especially with the passage of IRC 6050, requiring reporting by banks of payments made to merchants.

Recall that the AMT was initially intended to tax wealthy taxpayers who made use of loopholes to pay very little or no income tax. Though a full repeal of the AMT would indeed be costly, it may, at a minimum, be replaced with a tax targeted on those who can most afford to pay, such as an add-on tax for high-income taxpayers. This approach would be consistent with the original spirit of the AMT. Alternatively, this parallel tax system should undergo a major overhaul. Suggestions as to how this can be accomplished have been discussed in this paper. The current administration is looking for ways to jump start the economy by putting more money in the hands of the average citizen. Eliminating the burden of the AMT on the average taxpayer would surely be one way to achieve that goal.

Finally, if the AMT were to be repealed what would happen to credit carryforwards? Given the inequities illustrated in Exhibit 5 of this paper, this is indeed a question for further research.

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