The Alternative Minimum Tax: Repeal Not Reform

by Chris Edwards, Director of Tax Policy Studies, Cato Institute

The alternative minimum tax (AMT) is a federal income tax imposed on top of the basic income tax. The two income taxes have different deductions, exemptions, and tax rates. Unlike the basic income tax, the AMT is not indexed for inflation, with the result that its burden is expected to grow rapidly in coming years.

Without relief from Congress, 23 million taxpayers will pay the AMT in 2007. The average liability will be more than $3,000, and that added burden will hit most families by surprise. To avert a tax revolt, lawmakers would be wise to take action and repeal this unneeded tax.

Tax Experts Favor Repeal

The AMT was enacted in 1969, and the tax has grown steadily ever since. Taxpayers who might owe the tax are required to calculate their basic income tax and then recalculate their liability under the AMT. The AMT disallows certain benefits and uses different exemption amounts. The result is a broader tax base to which the AMT tax rates are applied. If the resulting tax amount is larger than the basic tax, taxpayers pay that higher amount.

Congress enacted the AMT to prevent people from taking too many breaks under the basic income tax. Disallowed breaks include personal exemptions and state and local tax deductions. But since it is Congress that put the special breaks into the tax code, the AMT is really just a Band-Aid to cover up the failure to create a simple and neutral tax base to begin with.

The AMT is not even an effective Band-Aid—it imposes burdens on taxpayers but creates no economic or social value. That’s why many experts favor AMT repeal. Groups supporting repeal include the Joint Committee on Taxation, the American Bar Association, the American Institute of Certified Public Accountants, the Tax Executives Institute, the National Taxpayers Union, and the Internal Revenue Service national taxpayer advocate. Former IRS taxpayer advocate Val Oveson called the AMT “absolutely, asininely stupid.”

High Cost to Taxpayers

In 2006, 4.2 million taxpayers paid about $25 billion in AMT. But if Congress does not extend relief provisions that had been in place in prior years, 23 million taxpayers will have to pay about $73 billion in AMT in 2007. That tax bill, averaging $3,161 per AMT taxpayer, will come on top of the burden of the basic income tax. Figure 1 shows that the average AMT burden will rise to $4,069 by 2012 when it will fall on 38 million taxpayers.

Both middle- and upper-income families will pay the AMT. Married couples with children and those living in high-tax states will be especially burdened. For example, of those earning between $75,000 and $100,000 with two children, 74 percent will be paying AMT by 2010.

Government Does Not Need Added Revenue

The AMT is expected to create large new tax burdens on families, yet the federal government does not need any extra revenue. Federal tax revenues rose 12 percent in fiscal 2006 and are on course to rise 8 percent in fiscal 2007, based on six months of data.
With all the Bush tax cuts in place, and if the AMT were fully repealed, federal revenues would still be more than 18 percent of gross domestic product this year. That GDP share is the average over recent decades, indicating that there is no shortage of revenues in Washington.

Despite rising revenues, the Bush administration is not leading efforts to repeal the AMT. Instead, it has adopted a position of fixing the AMT on a “revenue-neutral” basis. But that would mean a massive tax increase of about $1 trillion over the next decade, which is the amount of additional revenues the AMT is expected to generate. This position on the AMT, and the huge spending increases that President Bush has supported, are sadly jeopardizing the income tax cuts that he worked to secure.

Anti-Growth Effects

Some analysts argue that the basic income tax ought to be repealed and the AMT retained because it is more like a flat tax. Actually, it is nothing like the flat tax proposed by Steve Forbes, Dick Armey, and others. That flat tax is a simple, consumption-based system that is neutral toward savings and investment. By contrast, the AMT has a punitive treatment of savings and investment and retains all of the income tax system’s complex features such as capital gains, depreciation, and complicated rules on personal savings vehicles.

Another growth consideration is the effect of the AMT on marginal tax rates, which influence incentives to engage in productive activities such as working, saving, and investing. It turns out that the AMT raises marginal tax rates on more taxpayers than it cuts them on. In 2006 the AMT raised marginal rates on 71 percent of affected taxpayers, and by 2010 it will raise marginal rates on 89 percent of affected taxpayers.

Complexity

The IRS national taxpayer advocate argues that the AMT is a “poster child for tax-law complexity” and has repeatedly proposed its repeal. The advocate finds that the AMT is too complicated for most taxpayers to calculate and it often surprises families with burdens that they were not expecting and cannot afford to pay.

The taxpayer advocate also notes that most of the tax loopholes that the AMT were originally designed to correct have since been closed, thus leaving no policy purpose for the tax. Yet because Congress has not repealed the tax, millions of families have to spend an average 3.9 hours annually doing AMT paperwork, according to the IRS. With 23 million people set to pay the AMT in 2007, the total wasted time will be 90 million hours.

The AMT is onerous in other ways. Small and large businesses must perform additional record keeping for items such as depreciation. And the AMT burdens many businesses and individuals who don’t currently pay it because they need to perform calculations to see whether they owe it each year.

The AMT burdens the IRS with extra administrative costs, and it bogs down Congress with a recurring tax policy headache. Instead of moving ahead with tax reforms, Congress has spent its time tinkering with the AMT in more than 20 pieces of legislation since 1969. No doubt all those changes have kept tax lobbyists busy as well. The AMT wastes time and effort all around.

Conclusions

Some Democrats in Congress are considering raising AMT tax rates while adjusting AMT exemptions. But that would make the tax even worse and ignore the advice of experts to repeal it. The Bush administration’s position of raising other taxes to reform the AMT is also misguided.

Sen. Charles Grassley (R-IA) has the most sensible position on the AMT—full repeal with no revenue offsets. As Grassley noted on the floor of the Senate on April 18, projected future AMT revenues are “a phony revenue source,” and policymakers should not assume that they will receive that money. Rep. Phil English (R-PA) proposes to also repeal the corporate AMT because of its negative effects on manufacturing industries.

Congress passed an AMT repeal in 1999, but that legislation was vetoed by President Bill Clinton. This year, lawmakers have another chance to kill the complex and expensive AMT and make important progress toward tax code reform.

2 Data from the Joint Committee on Taxation, JCX-10-07, March 5, 2007, www.house.gov/jct/x-10-07.pdf. Figures include lost credits under the basic income tax.
3 Greg Leiserson and Jeffrey Rohaly, “The Individual AMT: Historical Data and Updated Projections,” Tax Notes, December 25, 2006. This is the cash income measure.
5 The administration proposes extending AMT relief for just one year.
6 This is the dollar value of providing partial relief for the AMT through 2017 by indexing it for inflation, assuming that the Bush tax cuts are extended.
7 Leiserson and Rohaly.