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The Individual Alternative Minimum Tax and its Unintended Consequences

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Abstract

The individual alternative minimum tax, commonly referred to as the AMT, remained relatively unchanged between its creation by Congress in 1969 until 2012. While the recent amendments to the tax were meant to prevent the tax from reaching individuals for whom it was never intended, the theoretical improvements may not be enough. The tax originally meant to only capture "high-income" taxpayers who were previously able to avoid paying income taxes, it has expanded its reach over the years to include a variety of taxpayers outside of this original intention. This paper examines the structure of the tax, and the items responsible for this tax's increasing reach as well as the economic implications on taxpayers and the overall economy.

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The Individual Alternative Minimum Tax and its Unintended Consequences

One would think at a time when the United States was engaged in assisting South Vietnam, more commonly referred to as the Vietnam War, this would be the most prevalent political topic that the public brought to the attention of Congress. However, it was a topic of the tax system and the issues it presented. In 1969, Treasury Secretary Joseph Barr alerted Congress and in turn the public that 155 high-income individual taxpayers had not paid a penny of federal income tax during 1966. Each of these individuals had an adjusted gross income at or exceeding $200,000, equivalent to roughly $1,417,247 in 2012 dollars.[1] News of this sparked uproar and Congress felt compelled to quash the taxpaying public outrage. Congress received more letters from the public regarding the unjustness of these individuals' tax burdens than the United States' involvement in the war. This outcry from the public had to be addressed in order to ensure the "share of the burden" was not being put completely on the middle class. In response Congress enacted the Tax Reform Act of 1969 (P.L. 91-172), which created a "minimum tax" to prevent high earning individuals from using tax laws to their advantage to the point of completely eliminating their federal income tax liability.

This "minimum tax" was the predecessor to the current Alternative Minimum Tax (AMT), which had its most significant alteration in the Tax Equity and Fiscal Responsibility Act of 1982 (P.L. 97-248). This Act converted the minimum tax from an add-on tax to the AMT and the parallel tax system in effect today.[2] The original intent of this system was to prevent only the top earners from avoiding any tax liability, but because the legislation did not index the tax to inflation it has been continually expanding its reach over the years. Not only does the tax fail to solely capture those originally intended, but also it has begun to hit middle class individuals and

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[1] CPI Inflation Calculator, *Bureau of Labor Statistics,* http://www.bls.gov/data/inflation_calculator.htm

[2] This means that the tax initially acted as an add on rate that all were subject to once their income reached a specific threshold. Today, it is a parallel system in which taxpayers must calculate their income tax using both systems.

couples. This unintentional failure of the system has caused damage to the economy as a whole through the continuation of a flawed and harmful tax.

The goal of this paper is to analyze several consequences the AMT creates for taxpayers, which have resulted from Congress' inability to properly correct the deficiencies of the Alternative Minimum Tax (AMT). Section one introduces the Alternative Minimum Tax, including the historical background and current state of the tax. Section two illustrates the direct impacts felt by taxpayers across America with a close look at the characteristics of those affected. Section three measures the short-term economic changes measured by the consumption function through the use of a MPC analysis and the AMT's lack of revenue generation. Section four will provide an analysis of multiple scenarios through the use of hypothetical tax returns. Based on the implications of these scenarios, a recommendation will be made as to best methods to correct the AMT. Finally, a conclusion regarding the failure of the system and suggestions for future research on the topic.

Basics of the Alternative Minimum Tax

Every taxpayer that prepares their individual income tax return must calculate both their "regular income tax" and must also check to see if the AMT applies to their return. The AMT is a calculation that makes certain adjustments to the taxpayer's "Taxable Income" and determines a "Tentative Minimum Tax". If the Tentative Minimum Tax is greater than the regular tax, the taxpayer is required to add the difference to their regular tax to bring the total income tax equal to the tentative minimum tax.

Figure 1: Alternative Minimum Tax Formula (2012)

	Taxable Income
+ or -	Adjustments to Taxable Income
+	Tax Preferences
=	Alternative Minimum Taxable Income (AMTI)
-	Exemption Amount
=	Net Alternative Minimum Taxable Income
x	26 or 28% Tax Rate
=	Tax
-	Alternative Minimum Tax Foreign Tax Credit
=	Tentative Minimum Tax (TMT)
-	Regular Tax for the Year
=	Alternative Minimum Tax (AMT)

(Source: CCH Federal Taxation Comprehensive Topics)

The Alternative Minimum Tax system was designed to ensure that certain taxpayers, especially high-income individuals couldn't reduce or eliminate paying "a fair share" of income taxes each year. One major difference is that the AMT consists of only a two-tiered tax rate system, currently set at 26 and 28 percent, while the Federal income tax has varying rates and exemptions dependant upon filing status. Figure 1 (above) displays the formula for calculating the AMT as of 2012. This will be the tax year used, as it is the first year in which the most current legislation was enacted and most recently available data sources.

Adjustments to Taxable Income and Preference Items

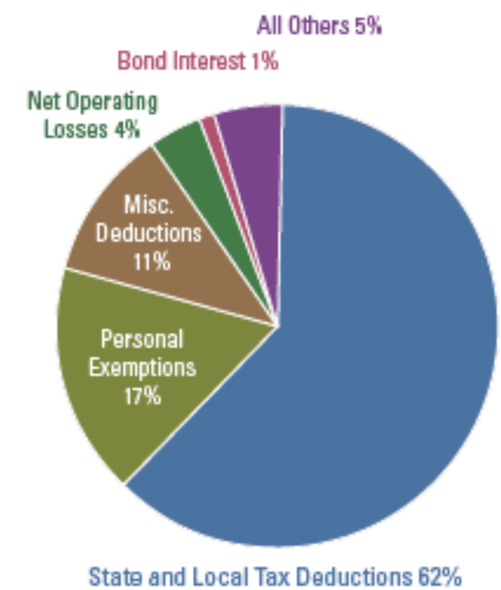
Once a taxpayer has determined their regular taxable income, adjustments must be made before reaching their alternative minimum taxable income (AMTI). The following provides a summary of usual items that are disallowed under the AMT. These items typically reduce taxable income and must be added back to increase your AMTI.

- **Incentive stock options-** Under AMT rules, the exercise of incentive stock options typically triggers AMT rules. The taxpayer must recognize the difference between the market price and the exercise price of the options as income.[3]
- **Personal exemptions-** When calculating AMTI, personal exemptions that are allowed under the regular tax calculation cannot be used to reduce one's tax liability under the AMT. Each exemption claimed on the regular tax must be added back to taxable income.
- **Standard deduction-** Like personal exemptions, the standard deduction is disallowed under the AMT rules and must be added back to taxable income.
- **Interest on second mortgages-** Under the regular tax system, the interest on home equity mortgages is deductible up to $100,000, no matter the purpose of the second mortgage. Under AMT rules, if the second mortgage is used for a purpose outside of financing a second home or making improvements to the residence, this interest deduction is disallowed and must be added back.
- **Miscellaneous itemized deductions-** While some miscellaneous itemized deductions are allowed, it is dependent upon a threshold. If the miscellaneous itemized deductions accounts for more than two percent of adjusted gross income (AGI), they must be added back. Examples of these items may include unreimbursed employee benefits, tax preparation fees, and investment expenses.
- **State and local taxes-** Any deductions taken under the regular tax system for state and local taxes are disallowed under the AMT. These taxes include property tax, state income tax, and state sales tax. The disallowance of these taxes makes those in high-tax states (such as California and New York) to be much more susceptible to a higher AMT amount.

[3] "The Alternative Minimum Tax." *Putnam Investments.* Accessed January 20, 2014.

Figure 2 below displays the top 5 AMT preference items as a share of positive adjustments for the 2008 tax year.

Figure 2: Top 5 AMT Preference Items as a Share of Positive Adjustments (2008)



(Source: Tax Policy Center)

P.A.N.I.C

To further distinguish adjustments to regular taxable income, P.A.N.I.C. focuses on items that can cause either an increase or reduction in regular taxable income for AMT purposes. The acronym P.A.N.I.C. is made up of:

- Passive Activity Losses
- Accelerated depreciation (on post- 1986 purchases)
- Net operating loss
- Installment income of a dealer
- Contracts- specifically percentage of completion versus completed contract

Each of these items is a voluntary election, which taxpayers can make. These elections create temporary differences that can either accelerate expenses or defer income, usually done for tax purposes. Each of the items included can cause either an increase or decrease and strictly affects those involved in business as opposed to the general taxpayer. For the purposes of this paper, the allowance and disallowance of these items is deemed acceptable for taxpayers using "loopholes" to reduce their tax liability.

T.I.M.M.E.

An additional categorical breakdown of adjustments to taxable income comes from the acronym T.I.M.M.E.. The items included in this category of adjustments are always added back to increase regular taxable income for the purposes of AMTI calculation. These items include:

- **Tax deductions-** These include state and local taxes as mentioned previously. Unfortunately for those living in high-tax states, there is a much higher probability that they will be affected by the AMT and pay a higher federal income tax liability. For this reason, this is one of the most pervasive AMT adjustment items that are included in the largest percentage of returns with AMT liability, 62 percent in 2008.
- **Interest deductions-** Generally, non-business interest is not deductible for AMT purposes. However, interest paid on debt that is used to acquire, construct, or improve a principal or second residence is allowed (home mortgage interest).
- **Medical deduction-** This amount is limited to any amount that is in excess of ten percent of adjusted gross income. This item while it is applicable and can affect all taxpayers rarely is a major cause for the AMT to kick in.
- **Miscellaneous disallowed deductions-** As previously discussed certain deductions are disallowed under AMT rules. While this item did account for the third largest percentage

of added back item in 2008 at 11 percent, it does not have the largest affect on AMT calculation compared to other items. This is because miscellaneous deductions are most commonly employee business expenses and are limited to two percent of adjusted gross income. This means that high-income taxpayers are much less likely to have deductions greater than two percent of their adjusted gross income than those with lower income levels.

- **Exemptions (personal) and standard deduction-** When calculating AMTI, personal exemptions that are allowed under the regular tax calculation cannot be used to reduce one's tax liability under the AMT. No deduction is allowed for the standard deduction or personal exemptions, and thus any used in computing original taxable income must be added back as an adjustment. Exemptions constituted the second most added back item at 17 percent in 2008. This can have a large impact on a taxpayer who claim a large number of dependants, and thus deters people from having larger families.

A key difference between P.A.N.I.C. items and T.I.M.M.E. is that the items included in the later always increase taxable income and affect every taxpayer. PA.N.I.C. items are also created by timing differences, while T.I.M.M.E. is not. Additionally, each of these T.I.M.M.E. items are mandated, rather than being elections. The requirement of these items that taxpayers are unable to avoid promotes the unfairness of these items.

State and local taxes account for the largest percentage of items added back on AMT returns and can in no way be planned for or avoided unless taxpayers move their principal residence to state with lower rates. For this reason those that live in a high-tax state such as California must add back a larger amount of these taxes to their taxable income. This negates the beneficial deduction they receive and thus reduces the amount of spendable dollars residents of high-tax states have. Although residences in these states have to pay larger income tax liabilities and state taxes, the argument can be made that although they pay this larger amount, the government services provided are not much different than those in a state such as Nevada, which does not have state taxes. This concept will be further discussed later in the paper, but it must be noted that alterations to the adjustments required under the AMT must be made.

Exemption Amount

For 2012, the exemption amounts were increased to $78,750 for married filing jointly, $39,375 for married filing separately and $50,600 for single individuals. Once the respective exemption amount has been subtracted from the AMTI, the net alternative minimum taxable income is multiplied by the corresponding tax rate. For 2012, the 26 percent tax rate applies to income up to $175,000 and the 28 percent applies to anything greater.[4] The AMT exemption amounts are reduced at a 25 percent rate for each dollar that the alternative minimum tax exceeds $150,000 for married couples, and $112,500 for singles.[5]

History: Evolution of the AMT

Originally, the first minimum tax was an add-on tax, in essence a relatively simple surcharge. This meant that there was a 10 percent minimum tax rate for add-ons in addition to the regular income tax. The main preference items included were capital gains, along with stock options, depreciations, and depletion allowances. Since its creation in 1969 the minimum tax has had numerous revisions, some 18 alterations in the last forty-five years.

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[4] Rohaly, Jeffrey and James Nunns, "Tax Provisions in the American Taxpayer Relief Act of 2012 (ATRA)", *Urban-Brookings Tax Policy Center,* (January 9, 2013), http://www.taxpolicycenter.org/uploadedPdf/412730-tax-Provisions-in-atra.pdf
[5] ibid.

The 1976 Tax Reform Act (P.L. 94-455) did not substantially change the law, simply adding certain itemized deductions as preferences. There was a more substantial change in the add-on tax rate, increasing the original 10 percent rate to 15 percent.

During President Jimmy Carter's presidency, many tax reform proposals were not approved. Despite this fact, Congress approved tax cuts geared toward upper-income groups, focusing on capital gains. Taxpayers were able to exclude 60 percent of long-term capital gains, thus only being taxed on the remaining 40 percent. With this exclusion, a 70 percent rate on the remaining 40 percent of the gain equated to a 28 percent rate on long-term capital gains. The Revenue Act of 1978 placed into law the alternative minimum tax (AMT) we know today. Although the Act called for $18.7 billion in tax cuts, it increased the percentage in taxes individuals would have to pay.[6] With the passage of this legislation much more extensive alterations were made. This was an entirely new tax, which was assessed on a taxpayer's regular taxable income increased by certain itemized deductions, and the excluded portion of capital gains income (capital gains income was dropped as a preference item under the add-on minimum tax). [7] According to media reports, it was indicated that the reductions in capital gains taxes would be offset by the increase in the AMT.[8] Also, during this time the United States' national debt had increased by $280 billion from $620 billion to $900 billion, nearing $1 trillion, but this growth in debt was outpaced by the economic growth minimizing federal debt to gross domestic product ratio.[9]

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[6] Goodman, Bonnie. "How did the Present Alternative Minimum Tax Come into Existence?" *History News Network.* Accessed January 20, 2015. http://www.historynewsnetwork.org/article/11819
[7] Maguire, Steven. "The Individual Minimum Tax for Individual". *Congressional Research Service.* (September, 2012).
[8] Ibid.
[9] Salvatore Lizzari. "The Crude Oil Windfall Profit Tax of the 1980s: Implications for Current Energy Policy." (March 2006). Accessed on February 28, 2015. http://assets.opencrs.com/rpts/RL33305_20060309.pdf

During the early 1980's Congress rejected Ronald Reagan's belief in supply-side economics, as they did not believe that a reduction in taxes could increase revenue.[10] During this time tax reform was a top priority as the economy was suffering a $900 billion deficit. To aid in this reform, in 1982 with the passage of the Tax Equity and Fiscal Responsibility Act (P.L. 98-369) the "add-on" minimum tax was repealed. Additionally, the Act altered the way in which the AMT tax operated. The AMT became a constant 20 percent tax rate on AMT income after personal exemptions of $30,000 (roughly $71,376 in 2012 dollars) for individuals and $40,000 (roughly $95,169 in 2012 dollars) for joint return filers.[11]

The AMT saw its most notable alterations with the passage of the Tax Reform Act of 1986 (P.L. 99-154). With this law, the AMT tax rate increased from 20 percent to 21 percent, the tax base was broadened, the basic exemption amount was changed, and the AMT tax credit was significantly altered.[12] This also made high-income taxpayers subject to phase-out exemptions once their AMT taxable income surpassed designated limits. The alteration in the tax treatment of capital gains was not meant to affect the AMT, but it resulted in a decrease in the number of taxpayers subject to the AMT. Under pre-1986 law, 60 percent of a long-term capital gain was exempt from regular income taxes. The excluded portion of the gain, however, was taxable as a tax preference under the AMT. [13] Since the 1986 Act repealed the exclusion for long-term capital gains income and capital gains income was taxed in full under the regular income tax, it was no longer taxed as a tax preference item under the AMT. [14] It was later discovered by investigative journalists that the AMT this year actually reduced taxes for the wealthy. It was reported in the

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[10] Ibid.
[11] Fleenor, Patrick, and Andrew Chamberlain. "Backgrounder on the Individual Alternative Minimum Tax (AMT)". *Tax Foundation.* (May 24, 2005). Accessed August 20, 2014. http://taxfoundation.org/article/backgrounder-individual-alternative-minimum-tax-amt
[12] Maguire, Steven. "The Individual Minimum Tax for Individual". *Congressional Research Service.* (September, 2012).
[13] Ibid.
[14] Ibid.

Philadelphia Inquirer that, "the toughest minimum tax ever' resulted in a 75 per cent drop in the number of people who paid the tax, and a 90 per cent drop in the amount they paid. On average, a millionaire in 1986 paid an alternative minimum tax of $116,395. Three years later, a millionaire paid $54,758. That amounted to a 53 per cent tax cut."[15]

With the budget deficit growing even larger and stated to reach as high as $231 billion, Congress and President Bush saw it as a time to create new taxes. The institution of the Revenue Reconciliation Act of 1990 (P.L. 101-509) increased the AMT rate to 24 percent. The next major changes came as a result of the Omnibus Budget Reconciliation Act of 1993 (P.L. 103-66), including an increase in AMT exemption amounts and alterations of the tax structure. AMT exemption amounts increased from $40,000 to $45,000 (from $63,555 to $71,500 in 2012 dollars), $30,000 to $33,750 (from $47,667 to $53,625 in 2012 dollars), and $20,000 to $22,500 (from $31,778 to $35,750 in 2012 dollars) for joint returns, taxpayers filing single returns, and married filing separately, respectively. The second major change this legislation instituted was the creation of a two-tiered tax rate structure for the AMT.[16] According to the legislation, for the first $175,000 of a taxpayer's AMT taxable income excess of the exemption was subject to a 26 percent tax rate, while alternative minimum taxable income in excess of $175,000 was subject to a 28 percent tax rate.

The Taxpayer Relief Act of 1997 (P.L. 105-34) provided the next alteration to the AMT. This act specifically altered how income from capital gains would be treated under both the regular income tax as well as the AMT. This established the maximum tax rate that could be applied to capital gains under the regular income tax as well as being applied under the alternative minimum tax, 20 percent.

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[15] Goodman, Bonnie. "How did the Present Alternative Minimum Tax Come into Existence?" *History News Network.* Accessed January 20, 2015. http://www.historynewsnetwork.org/article/11819
[16] Ibid.

Soon after, the Omnibus Consolidated and Emergency Supplemental Appropriations Act of 1999 (P.L. 105-277) provided allowances applicable only for the 1998 tax year. The focus of which was the allowance of nonrefundable tax credits to offset the regular income tax. This was allowed despite the fact that the personal tax credits could exceed the difference between the taxpayer's regular income tax and his minimum tax. Additionally, this act repealed the provision that reduced various tax credits, but only for the 1998 tax year.

The next legislative change that the AMT saw came with the Tax Relief Extension Act of 1999 (P.L. 106-170), as it extended the current provision in place. In effect until the end of December 2001, the provision allowed taxpayers to offset their regular income tax by the full amount of their nonrefundable personal tax credits, regardless of the AMT.[17]

In 2001, the Economic Growth and Tax Relief Reconciliation Act (EGTRRA; P.L. 107-16) increased allowances for individuals to claim varying credits. These included the child tax credit, adoption tax credit, and the IRA contribution tax credit, each of which could be claimed to the full amount of the regular income tax and the alternative minimum tax. These provisions of the EGTRRA expired after 2010. Additionally, the EGTRRA altered the exemption amount by $4,000 ($5,185 in 2012 dollars) for those filing joint returns and $2,000 ($2,593 in 2012 dollars) for unmarried filers.

The Jobs Creation and Worker Assistance Act of 2002 (JCWAA; P.L. 107-147) saw the continuation of the previous extension of the provisions created in 1998, which allowed taxpayers to use all personal tax credits against both regular and alternative minimum tax liabilities. This extension of the temporary provisions was intended to be applicable only until the end of December 2003.

[17] ibid.

In 2004, the provision previously extended only through 2003, was continued through 2005 with the passage of the Working Families Tax Relief Act of 2004 (WFTRA; P.L. 108-311). In addition to extending these provisions, the basic AMT exemption amounts were also increased for the year.

During the same year, the American Jobs Creation Act (AJCA; P.L. 108-357) was passed and provided new alterations to the AMT. Since income averaging was pushing taxpayers into the AMT, this act coordinated income averaging for both farmers and fishermen so they would not be subject to the minimum tax due to income averaging. Also, it repealed the limitation placed on foreign tax credits and allowed credits for alcohol used as fuel and electricity produced by renewable resources to be used against the AMT in full.[18]

The next increase in the AMT exemption amount came from the Tax Increase Prevention and Reconciliation Act of 2005 (TIPRA; P.L. 109-222). First, the act increased the AMT exemption amounts to $62,550 and $42,500 for joint and unmarried taxpayers, respectively. In addition, the provisions allowing nonrefundable personal tax credits to offset the AMT were extended through 2006.

In 2006, an entirely new change to the AMT was made with the passing of the Tax Relief and Health Care Act of 2006 (P.L. 109-432). This allowed taxpayers to claim the credit of the prior year's minimum tax refundable. Taxpayers could claim the "greater of (1) the lesser of $5,000 or the unused minimum credit, or (2) 20% of the unused minimum credit."[19] Depending on the taxpayer's adjusted gross income, the AMT credit was reduced. In 2009, the threshold amounts for this adjusted gross income was $250,200 for joint returns. This provision was applicable to through tax years up to January 1, 2013.

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[18] ibid.
[19] ibid.

Again in 2007, the Tax Increase Prevention Act (P.L. 110-166) increased the AMT exemption levels. The new AMT exemption thresholds were set at $66,250 and $44,350 for joint and single filers, respectively. In addition, the nonrefundable personal tax credits were able to offset AMT liability for the 2007 tax year.

The AMT patches continued into the 2008 tax year as a part of the Emergency Economic Stabilization Act of 2008 (P.L. 110-343). The Tax Extenders and Alternative Minimum Tax Relief Act was included as a piece of the Stabilization Act in an attempt to bring relief to a failing economy. This patch again altered and increased the exemption amounts for the AMT to $69,950 and $46,200 for joint and single filer, respectively. Also, the personal credits used to offset the AMT liability was allowed to continue, while the incentive stock option AMT liability was removed.

The American Recovery and Reinvestment Act of 2009 (ARRA; P.L. 111-5) created another single year patch in the AMT exemption amounts, as well as allowing the personal credits against the AMT to continue. The new exemption rates were set to $70,950 for joint filers, and $46,700 for singles. As this patch was only for the 2009 tax year, the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 (P.L. 111-312) provided the next patch for 2010 and 2011. Again the exemption amounts increased as a temporary fix. The new exemption amounts were $72,450 for joint filers and $47,450 for singles in 2010 and $74,450 for joint filers and $48,450 for single filers in 2011.

Table 1: Summary of Legislative Changes to the AMT

		Impact on AMT			
Year	**Legislation**	**Joint Filers Exemption**	**Single Exemption**	**Tax Rates (Percentage)**	**Other Changes**
Add-On Tax					
1969	Tax Reform Act of 1969 (P.L. 91-172)	$30,000+regular tax	$30,000+regular tax	10	Capital gains, depreciation, and stock options are main preference items.
1976	Tax Reform Act of 1976 (P.L. 94-455)	Greater of $10,000 or 1/2 regular tax	Greater of $10,000 or 1/2 regular tax	15	Some itemized deductions added as preference items.
Alternative Minimum Tax					
1978	Revenue Act of 1978 (P.L. 95-600)	$20,000	$20,000	10 on $0-$40k 20 on $40k-80k 25 on $80k+	Certain itemized deductions and capital gains moved to tax base of AMT.
1982	Tax Equity and Fiscal Responsibility Act of 1982 (P.L. 97-248)	$40,000	$30,000	20	Repealed "add-on" minimum tax.
1986	Tax Reform Act of 1986 (P.L. 99-514)	No Change	No Change	21	Increased number of tax preferences. Allowed an income tax credit for prior year AMT liability.
1990	Omnibus Budget Reconciliation Act of 1990 (P.L. 101-508)	No Change	No Change	24	Raised AMT rate to 24%.
1993	Omnibus Reconciliation Act of 1993 (P.L. 103-66)	$45,000	$33,750	26 on $0-$175k 28 on $175k+	Changed rules about gains on stock of small businesses.

Alternative Minimum Tax					
1997	Taxpayer Relief Act of 1997 (P.L. 105-34)	No Change	No Change	No Change	Changes regarding depreciation and farmers' installment sales.
1998	Tax Technical Corrections Act of 1998 (P.L. 105-206)	No Change	No Change	No Change	Adjusted AMT for new capital gains rates.
1999	Tax Relief Extension Act of 1999 (P.L. 106-170)	No Change	No Change	No Change	Changed rules about nonrefundable credits.
2001	Economic Growth and Tax Relief Reconciliation Act (EGTRRA; P.L. 107-16)	$49,000 (2001-2004)	$35,750 (2001-2004)	No Change	Increased allowance of multiple credits.
2002	Jobs Creation and Worker Assistance Act of 2002 (JCWAA; P.L. 107-147)	No Change	No Change	No Change	Continued extension of 1998 provisions, applicable until end of December 2003.
2005	Tax Increase Prevention and Reconciliation Act of 2005 (TIPRA; P.L. 109-222)	$62,550 (2006)	$42,500 (2006)	No Change	Extended provision allowing nonrefundable personal tax credits.
2006	Tax Relief and Health Care Act of 2006 (P.L. 109-432)	No Change	No Change	No Change	Allowed taxpayers to claim the credit of prior year's minimum tax refundable.
2007	Tax Increase Prevention Act of 2007 (P.L. 110-166)	$66,250 (2007)	$44,350 (2007)	No Change	Extended provision of nonrefundable personal credits.
2008	Emergency Economic Stabilization Act (P.L. 110-343)	$69,950 (2008)	$46,200 (2008)	No Change	Extended nonrefundable credits, while eliminating incentive stock option liability.

Alternative Minimum Tax					
2009	American Recovery and Reinvestment Act (ARRA; P.L. 111-5)	$70,950 (2009)	$46,700 (2009)	No Change	Extended allowed use of nonrefundable personal credits.
2010	Unemployment Insurance Reauthorization, and Job Creation Act (P.L. 111-312)	$72,450 (2010) $74,450 (2011)	$47,450 (2010) $48,450 (2011)	No Change	Extended use of nonrefundable personal credits through 2011.

(Source: Tax Policy Center)

The Current Position

With the fiscal cliff looming over both the government of the United States and the taxpaying citizens, action needed to be taken and the push for change was encapsulating the political sphere. In order to avoid the affects of passing this “Fiscal Cliff”, the House and Senate passed legislation on January 1, 2013, which was signed into law by President Obama on January 2, 2013. The legislation, the American Taxpayer Relief Act of 2012, prevented tax increases that had the potential to affect over 98% of American taxpayers.[20] Essentially, the Act extended the Bush-era tax cuts (EGTRRA), increased income tax rates, increased long-term capital gains rates on higher earning taxpayers, and in theory, permanently fixed the Alternative Minimum Tax.[21] To the general public this act appeared to be a blessing as it meant that as related to the AMT, a smaller percentage of the middle-class would be faced with the AMT. While the indexation was thought to be a complete fix for the tax, ensuring the upper class paid their fair share; the actual result is much less clear-cut.

[20] Bureau of National Affairs, “BNA Analysis of the American Taxpayer Relief Act of 2012”, (January 2013), Accessed November 13, 2014, http://www.bna.com/uploadedFiles/Content/Landing_Pages/FISCAL_CLIFF/bna-analysis-taxpayer.pdf
[21] ibid.

For tax years beginning in 2012, the AMT exemption amounts were altered to $78,750, $50,600, and $39,375 for joint returns, individual filers, and married filing separately, respectively. Additionally, in theory the Act prevented further year-by-year corrections by indexing the AMT for inflation each year. According to 26 U.S. Code § 55, these exemption amounts shall be increased by an amount equal to the amount multiplied by the cost-of-living adjustment determined for the calendar year.[22] This cost-of-living adjustment for any calendar year after 2012 will be calculated as the percentage by which the Consumer Price Index (CPI) for the preceding calendar year exceeds the CPI for the calendar year 2011.[23] For the purpose of this calculation, “Consumer Price Index” means the most recent Consumer Price Index for all-urban consumers published by the Department of Labor.[24] Finally, any increase that is calculated must be rounded to the nearest multiple of $100.

Analysis of Tax Problem

The Alternative Minimum Tax has continually posed many issues for taxpayers over the years of its existence. This tax presents an additional step for taxpayers to complete while being extremely complex and burdensome to do so. Not only has the AMT strayed away from its original target of the top income earners in the country, it has also began to penalize taxpayers for many common characteristics. At present information of tax filings for the 2013 year (most current year filed) have not been published, as such the statistical information presented for 2012 will be/has been used. While it is not distinguished in the original Congressional legislation for this paper it will be assumed that the AMT, which was only supposed to hit “top income earners”

[22] "26 U.S. Code § 55 - Alternative Minimum Tax Imposed." *26 U.S. Code § 55*. Cornell University Law School, n.d. Web. 13 Dec. 2014.
[23] "26 U.S. Code § 1 - Tax Imposed." *26 U.S. Code § 1*. Cornell University Law School, n.d. Web. 13 Dec. 2014.
[24] Ibid.

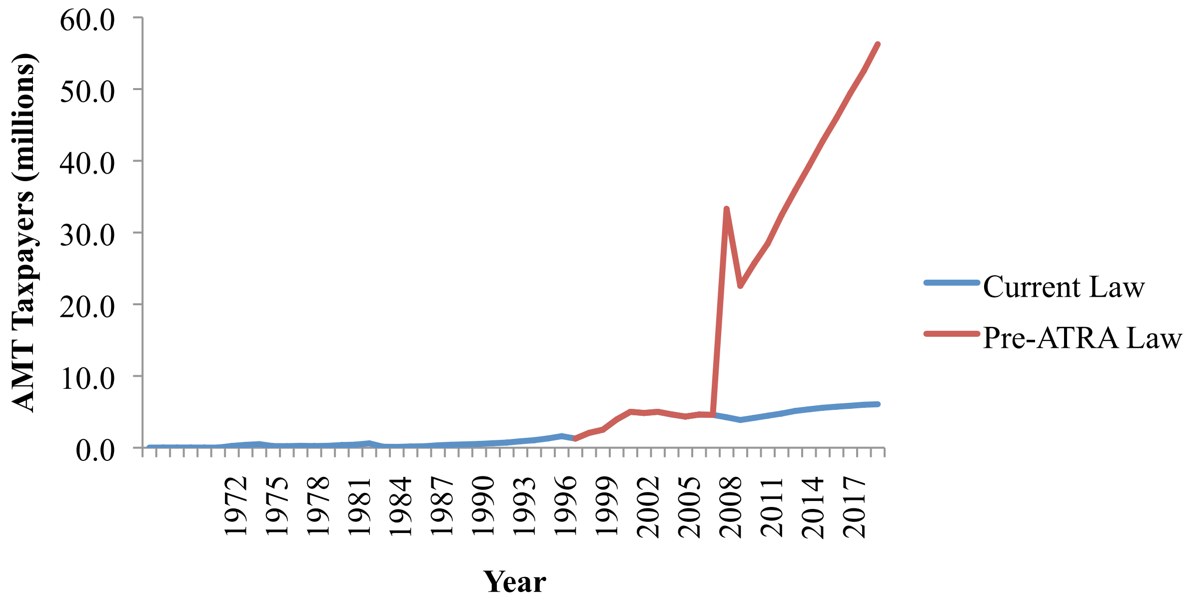
was intended for the top two to three percent of income earners in the country. According to the United States Census Bureau, the lower limit of the top five percent of income earners for 2012 was roughly $200,000 and the median income of the top five percent was $318,000.[25] Based on these statistics and based on the number of returns filed in 2012, returns with incomes $500,000 or greater accounted for just over two percent of total returns filed. For the purposes of this paper, an individual earning $500,000 or more per year will be considered to be “high-income” and within the original intention of the AMT. While those with incomes between $50,000 to $250,000 will be considered “low-income” or “lower middle class”.

Expanding Reach of the AMT

As the AMT has continued to expand its reach across taxpayers, the taxpayers which are being most affected have evolved over the years. Below, Figure 3 displays the aggregate number of AMT filers by tax year Pre-ATRA and under the current law, including projections for future years. While the implementation of ATRA has controlled and prevented a larger percentage of taxpayers from being subject to the AMT, the composition of these taxpayers is ever changing.

[25] “Table H-1. Income Limits for Each Fifth and Top 5 percent” *United States Census Bureau.*

Figure 3: Aggregate AMT Projections, 1970-2023

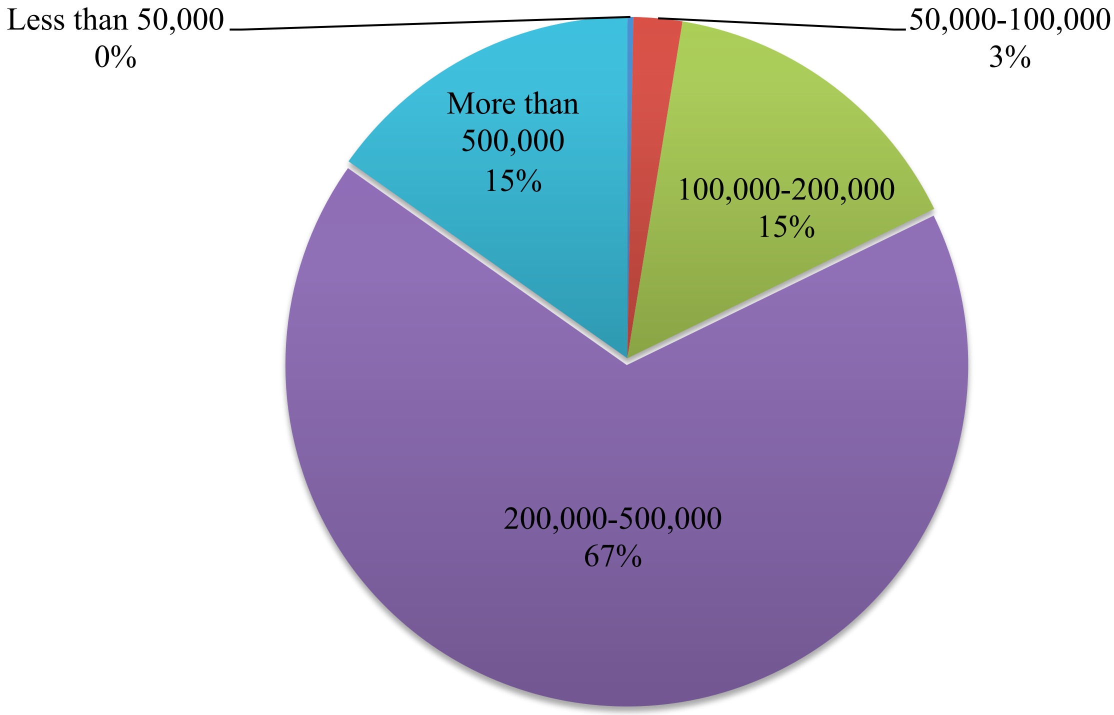


(Data Source: Tax Policy Center, Table T13-0208)

When initially enacted, the average taxpayer subject to the AMT was a small number of high-income individuals, only 500,000 taxpayers.[26] These high-income individuals tended to itemize their deductions and take advantage of the preference items that are allowed under itemizing. However, over the years, this average taxpayer has become one of much lower income who faces the AMT due to disallowance of many commonly used tax items. One of the main disallowed items, which capture a larger percentage of taxpayers, comes from the personal exemption, which all taxpayers use on their regular return. Additionally, those who do not itemize, roughly two-thirds of taxpayers, are unable to use the standard deduction as they are in their regular income tax computation. The disallowance of these items causes a greater percentage of taxpayers to be captured in lower income brackets.

[26] "Characteristics of AMT Taxpayers, 2012-2014, 2023." *Tax Policy Center.* (August 23, 2013). Accessed on January 20, 2014. http://www.taxpolicycenter.org/numbers/displayatab.cfm?DocID=3969

Figure 4: Composition of 2012 Taxpayers Affected by the AMT, by AGI

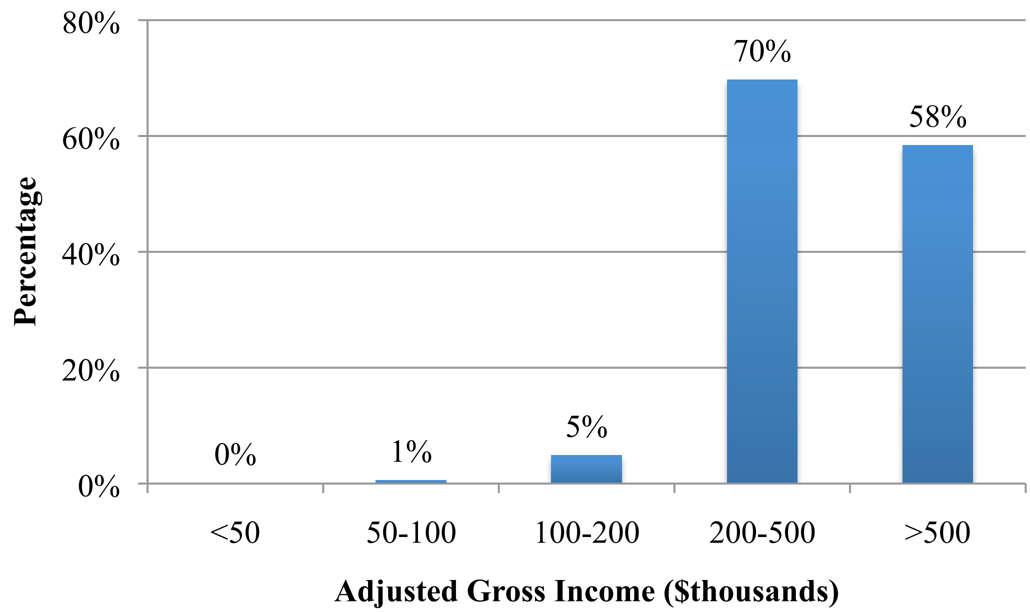


(Data Source: Internal Revenue Service)

Figure 4 displays the composition of taxpayers affected by the AMT according to their adjusted gross income in tax year 2012. During 2012, taxpayers with an adjusted gross income between \$200,000 and \$500,000 made up 67 percent of total AMT payers. The next closest were individuals with an AGI between \$100,000 and \$200,000 or those having more than \$500,000, each composing 15 percent of AMT payers. According to the Congressional Budget Office, in 2009 taxpayers with an AGI between \$200,000 and \$500,000 made up 62 percent of total AMT payers, while those having AGI above \$500,000 only accounted for 10 percent of AMT payers.[27] An additional breakdown of the data for AMT filers by their adjusted gross income is the percentage of the total filers in each AGI range that fell victim to the AMT. Below, in Figure 5, this statistic is portrayed.

[27] Shaking, Joshua. "The Individual Alternative Minimum Tax". *Congressional Budget Office.* (January 2010).

Figure 5: Percentage of Total Taxpayers Affected by AMT, by AGI for 2012



(Data Source: Internal Revenue Service)

As displayed by Figure 5 above, again the AGI range that was most impacted by the AMT were those with AGI between $200,000 to $500,000. Of the roughly 3.9 million taxpayers that fell within this AGI range, 2.7 million had to pay an AMT liability, equating to just fewer than 70 percent. The next group with the most AMT filers was those with AGI greater than $500,000. Although there were just over 1 million taxpayers in this AGI range, roughly 620,000 filed AMT claims, or 58 percent. Finally, those with AGI between $100,000 to $200,000 had 5 percent of taxpayers file AMT claims. Although a large percentage of high-income individuals were affected, not all were. This range of individuals being impacted by the AMT differs greatly from the original intention of the top percentage of income earners.

Common Taxpayer Characteristics

While the AMT was originally enacted with the purpose of only affecting the top income earners in the country, the number of taxpayers forced to pay this tax has continued to grow over the years. Taxpayers who have not properly completed tax planning may find themselves faced with the AMT because of items that previously had been considered tax benefits no longer are tax benefits. These items include having multiple children, being married, and living in high-tax states. For the computation of an individual's regular income tax each dependent is granted the dependency exemption, this must be added back under the AMT computation. Below Table 2 displays the Tax Policy Center's characteristics of AMT taxpayers as a percentage of those affected by the AMT.

Table 2: Percentage Affected by the AMT, Before and After ATRA

Group	Current Law 2012	2013 Current Law	2013 Pre-ATRA Law	2014 Current Law	2014 Pre-ATRA Law	2023 Current Law	2023 Pre-ATRA Law
All Taxpayers	4.6	4.2	22.7	4.3	25.0	5.4	47.8
All Tax Filers	3.1	2.8	16.1	2.9	18.1	3.8	35.6
All Tax Units	2.7	2.4	13.9	2.6	15.8	3.5	32.6
Tax Units							
By Expanded Cash Income (thousands of 2013$)							
Less than 30	<0.05	<0.05	0.1	<0.05	0.1	<0.05	0.6
30-50	<0.05	<0.05	2.3	<0.05	2.5	<0.05	7.2
50-75	0.6	0.5	7.9	0.6	9.5	0.8	24.0
75-100	1.8	1.8	20.6	1.9	23.8	2.3	43.7
100-200	1.9	1.9	44.1	1.8	46.4	2.2	78.2
200-500	32.5	29.3	67.8	32.3	71.9	25.4	94.6
500-1,000	85.0	63.7	31.7	61.6	31.7	67.6	38.2
1,000 and more	39.3	18.0	11.1	20.8	13.0	20.2	12.5
By Number of Children							
0	2.4	2.1	6.8	2.3	8.0	3.1	26.3
1	3.4	3.1	23.9	3.3	27.7	4.2	47.0
2	4.7	4.1	38.9	4.4	42.2	5.6	56.7
3 or more	6.3	5.8	49.3	6.0	53.1	8.5	65.0
By State Tax Level							
High	4.5	4.1	19.8	4.2	21.6	5.8	38.6
Middle	2.9	2.7	16.6	2.9	18.6	3.8	37.4
Low	1.9	1.6	12.3	1.8	14.4	2.1	31.4
By Filing Status							
Single	0.9	0.8	1.8	0.9	2.0	1.3	7.6
Married Filing Joint	4.9	4.3	28.9	4.6	32.4	5.8	61.9
Head of Household	1.2	1.1	14.3	1.0	16.9	1.6	31.3
Married Filing Separate	26.9	23.7	61.5	26.7	63.9	30.0	73.0
Married Couple, 2+ Kids, 75k<Exp Cash Income<100k	<0.05	<0.05	38.6	<0.05	43.7	<0.05	76.2
Married Couple, 2+ Kids, 75k<AGI<100k	0.1	<0.05	89.2	0.1	89.5	0.1	98.4

(Source: Tax Policy Center)

The comparison between Pre-ATRA and current law displays the potential meltdown that was avoided through the passage of ATRA. For example, a married couple with 2 children and AGI between $75,000 and $100,000 in 2023 was anticipated that 98.4 percent of these filers would be faced with the AMT pre-ATRA. Now due to the indexing occurring only 0.1 percent of these taxpayers are anticipated to have to pay the AMT in 2023. While the indexing that now occurs thanks to ATRA does decrease the number of affected taxpayers, the tax preference items will still cause issues for many. In 2012, 4.5 percent of AMT payers lived in a state with a high level of state taxes, compared to just 1.9 percent in low tax states. This shows the negative impact of the AMT's attempt at protecting against tax loopholes, that actually cause penalties for uncontrollable factors.

Additionally, the impact of marriage and children are opposite of their effect on the regular income tax. While the regular computation encourages individuals to get married due to marriage benefits and have children to take advantage of dependent exemptions, the AMT instead discourages this. As shown, only 2.4 percent of households with no children were faced with the AMT, while this number jumped to 6.3 percent for those having three or more children.

Effects on Tax Incentives

While the AMT can directly impact an individual's tax liability, it may also have an unintentional indirect impact on the decisions and behaviors of taxpayers. As mentioned previously, additional children are encouraged under the regular tax system yet discouraged under the AMT. Although the child tax credit is still permitted under the AMT, the personal exemptions must be added back and instead a single exemption amount is used. This amount is based solely on the taxpayer's filing status, thus eliminating the difference between being a large or small family.

Another tax incentive under the regular system that is disallowed under the AMT is the deduction for state and local taxes. The disallowance of this deduction is what causes the increased likelihood that individuals living in high tax states will be captured by the AMT. Under the regular tax system, the deduction of these taxes acts a subsidy because it decreases the net cost to taxpayers, which in turn allows state and local governments to impose higher taxes and provide more services to residents.[28] The disallowance of this deduction causes similar taxpayers (based on adjusted gross income) that live in different states to be faced with alternate versions of the AMT as well as limiting this state subsidy to local governments. A final distinction between the AMT and regular tax's view on different states is how they are distinguished. The regular tax distinguishes taxpayers by the amount and type of state and local financing where they live, while the AMT treats these similar taxpayers in separate areas as comparable.[29]

Increased Complexity

For taxpayers, the AMT is simply another tax that they more likely or not do not understand fully. Unfortunately for many, the AMT does not work in favor of those that itemize deductions, have multiple children, and those that pay high state taxes. Again, this tax was meant to only capture the top few percent of income earners in the country, but has continued to capture more and more than originally meant.

Not only is there the issue of the expanding reach of the AMT, but also the complexity of the tax increases the amount of time that must be spent on each return. It was estimated that people spent over 18 million hours determining if they needed to file AMT or not, coming out to 12 hours per person who actually paid the AMT, while the entire 1040 is estimated to take 22

[28] ibid.
[29] ibid.

hours to fill out.[30] This shows that the AMT's complexity creates more work than it should, for average taxpayers and preparers alike. Unfortunately it appears that even tax software cannot help lessen the burden enough for self or professional preparers. A recent study found that about 67 percent of Forms 6251 (the Alternative Minimum Tax- Individuals IRS document) received was unnecessary.[31]

In addition to the process of filing the proper tax forms, the AMT complicates what once was a simple choice, to itemize deductions or not. Previously taxpayers could either use the standard deduction, a flat deduction amount dependent on filing status, or elect to itemize deductions. Taxpayers can calculate each and chose whichever amount is greater. Now that the AMT has begun to reach much lower income individuals, those making these elections must be knowledgeable of their vulnerability to make the proper choice. No longer is the election as simple as choosing the greater amount, as many itemized deductions that are allowed under the regular income tax are disallowed under the AMT.

Marginal Tax Rates

While the AMT is structured in a two-tiered system with tax rates at 26 percent on the first $175,000 and a 28 percent rate on anything above that threshold. The regular tax has a bracket system, with brackets at 10, 15, 25, 28, 33, and 35 percent. This means that the highest rate an individual can be taxed at under the regular system is 35 percent and while the highest level is only 28 percent under the AMT system. While this may appear as though the AMT is favorable by having a lower tax rate, this in fact is not the case. The effective marginal tax rate must be taken into consideration in order to understand the impact taxpayers are facing. While some taxpayers are able to face a lower marginal tax rate under the AMT many face a much

[30] ibid.
[31] ibid.

higher rate. According to the Congressional budget Office, "the AMT has less effect on the highest-income taxpayers (because the top rate of 35 percent under the regular tax is higher than the top statutory rate under the AMT) and the lowest-income taxpayers (because the AMT's exemption shields most of them from the alternative tax)".[32]

As shown in Table 3, the last two columns display the average effective marginal tax rate as a percentage that individuals face according to the expanded cash income class. The comparison before and after the AMT displays the difference that the AMT can play in the marginal rate. All income classes except for the highest ($1,000,000 or more) faced a higher marginal rate after the AMT than before. The average taxpayer's marginal tax rate increased by four percent due to the AMT.[33] Not only does this result in an increase in tax liability, but the increase in marginal tax rates causes a reduction in after-tax wages and can thus discourage people from working as they need to work more in order to reach the same amount of after-tax income.[34]

[32] ibid.
[33] ibid.
[34] ibid.

Table 3: Effective Marginal Tax Rates in Regular Income Tax and the AMT, AMT Payers Only

Expanded Cash Income Class (thousands of 2013$)	Percent with More Income Subject to Tax In		Average Adjustments and Preferences	Percent with a Higher Marginal Tax Rate In		Average Effective Marginal Tax Rate (percent)	
	Regular Tax	AMT		Regular Tax	AMT	Before AMT	After AMT
Less than 30	n/a	n/a	n/a	n/a	n/a	n/a	n/a
30-50	85.8	14.2	18,428	0.0	70.3	14.3	27.4
50-75	98.2	1.8	13,520	0.0	98.5	22.3	33.4
75-100	96.5	3.5	13,924	0.0	99.6	24.5	37.6
100-200	67.1	33.0	25,002	1.4	96.1	25.3	35.9
200-500	72.4	27.6	37,404	3.2	96.1	29.3	34.0
500-1,000	6.4	93.6	54,364	48.4	45.4	32.4	31.2
More than 1,000	0.2	99.8	206,150	69.5	20.2	29.5	27.2
All	59.1	40.9	46,714	13.8	83.8	28.7	33.6

(Source: Tax Policy Center)

The reason that most high-income earners are not faced with an increased marginal rate is due to the low tax rates on investment income. As an individual's income increases, the higher income earners tend to earn their income through investments, rather than wages. Investment income items face much lower tax rates under both the regular system and the AMT compared to the typical wages that moderate-income taxpayers earn. Currently long-term capital gains and qualified dividends are taxed at much lower rates, roughly 15 percent under each system. As mentioned by the Taxpayer Advocate, "taxpayers who have sufficient resources to live off of investment income pay tax at 15 percent – less than the 25 percent marginal rate applicable to a single person who earns just $34,501 in taxable income form wages".[35]

[35] "The Alternative Minimum Tax Corrodes Both the Tax System and the Democratic Process", *Taxpayer Advocate Services,* http://www.taxpayeradvocate.irs.gov/userfiles/file/Full-Report/Most-Serious-Problems-Alternative-Minimum-Tax.pdf

Short Term Economic Analysis

The economic implications of higher taxes are two-fold, a positive for the government and a negative for the public consumer. While the government is able to generate more revenues through higher tax collections, household wealth decreases, which can be measured by disposable income. Disposable income is defined as, "total personal income less total personal current taxes."[36] This means that it is the ability of a consumer to purchase goods and services as well as pay off any expenses, such as taxes, while any income not spent is saved. Based on this definition, if income does not increase at the same or faster rate as the rate of personal current taxes, disposable income will decline and consumer spending will decrease. The consumption function is used to measure the effects, given by:

$$C = a + bY_d$$

Where the relationship between disposable income (Y_d) and consumption (C) is explained through factors such as autonomous spending (a) and marginal propensity to consume (b) also referred to as MPC. The higher the tax rate, the lower the level of spending will be for the consumer. This impact on households has a direct impact on the economy as a whole since it depends upon who is being affected more, the rich or everyone else.

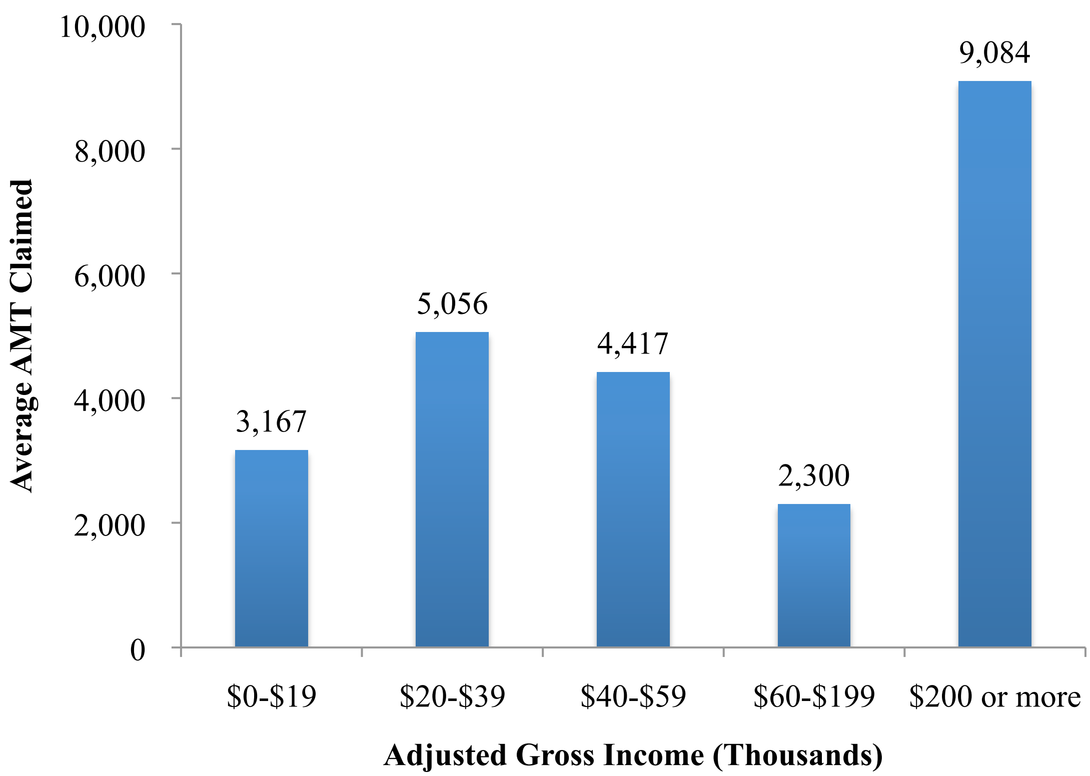
Consumer Perspective: MPC Analysis

An increase in taxes will cause a decrease in disposable income and cause a reduction of spending within the economy. Under the AMT system, taxpayers are facing increased tax liabilities and thus a decrease in their disposable income. Figure 6, shows the average AMT amount taxpayers had based on their adjusted gross income for the 2012 tax year. The overall average AMT amount for 2012 was $7,887, this means that taxpayers that filed the AMT on

[36] "Disposable Income Definition | Investopedia." *Investopedia.* N.p., n.d. Web. Jan. 2015.

average had $7,887 less to use on consumption. While this may not appear to be much money, to put it in perspective, there were just over four million taxpayers subject to the AMT with total claims of $32 billion.

Figure 6: Average AMT Claim, by AGI for 2012



(Data Source: Internal Revenue Service)

A consumer's marginal propensity to consume (MPC) shows their desire to spend outside of their autonomous spending (spending that will occur no matter income level). The higher the MPC, the more of each dollar a consumer is spending. This means that if MPC is equal to 0.9, the consumer is spending ninety cents of every dollar earned. Alternatively, the consumers marginal propensity to save (MPS) is just the opposite, calculated by 1-MPC. The MPC and MPS are not held constant and often are dependent on the income level of the individual. A study conducted in 2004 by Dynan, Skinner and Zeldes investigated how income level impacted likelihood of individuals to spend and save. Based on this study, it was proven that families with higher income (the rich) were more inclined to save, while lower income families were more spending more.[37] This means that when lower income taxpayers are forced to pay a higher tax liability due to the AMT, that money could have been spent in the economy promoting growth rather than simply being a drop of revenue in the bucket. Alternatively, by high-income taxpayers not facing as large of tax implications as they could, rather than spending this additional money they simply save it and do not promote any economic growth. Overall, the economic implications of the AMT show it is preventing growth in an attempt to gain just a bit of extra revenue.

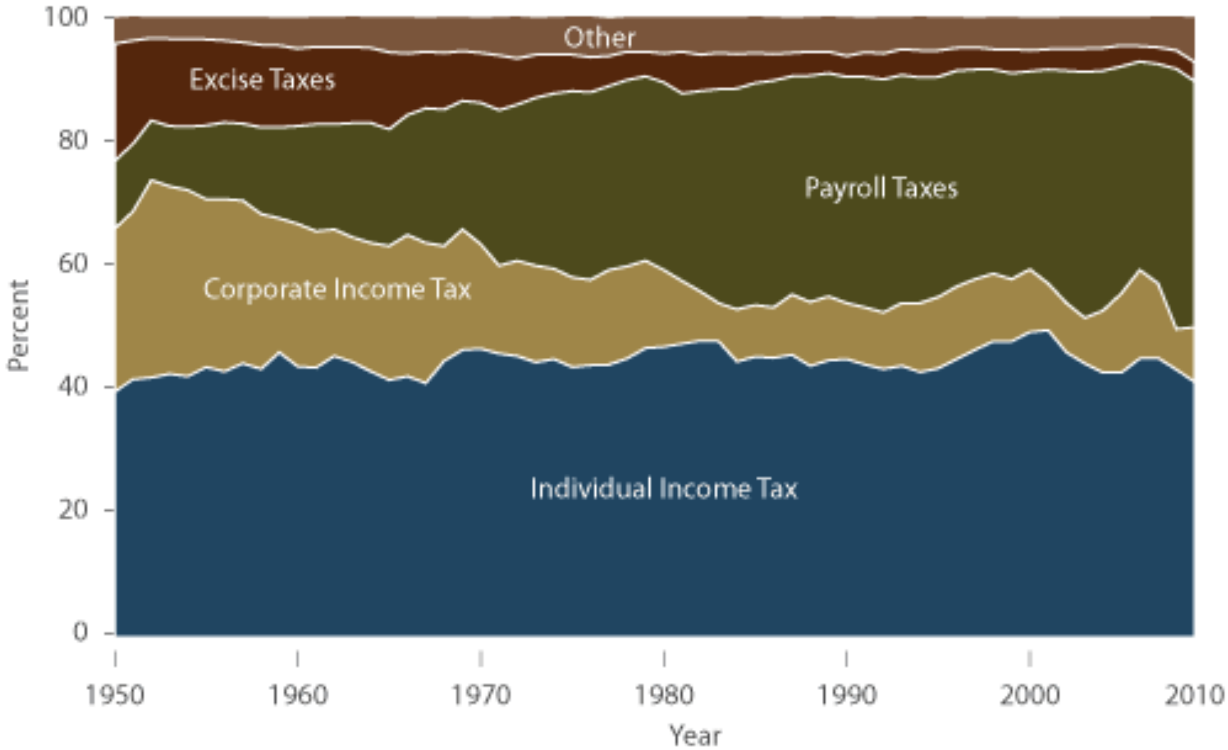
Government Perspective: Lack of Revenue Generation

The variety of taxes paid to the Federal government each year has begun to account for a larger percentage of total revenues. According to the Tax Policy Center, individual income and payroll taxes accounted for 82 percent of all federal revenues in 2010, with corporate income taxes contributing 9 percent, and excise taxes as well as miscellaneous receipts making up the remaining balance.[38] The changes in this proportion have been relatively miniscule over the years. Payroll taxes have seen a large increase, while excise taxes have fallen through the last half-century. The Federal government has generated revenues ranging from 14.4 percent of Gross Domestic Product (GDP) in 1950 to 20.6 percent in 2000, with an average of 17.9 percent over the last fifty years.[39] Over these years, personal income taxes have accounted for the largest portion of revenues generating roughly 8 percent of GDP, while corporate income tax and excise

[37] Dylan, Karen E., Jonathan Skinner, and Stephen P. Zeldes. "Do the Rich Save More?" *Journal of Political Economy* 112.2 (2004).
[38] Williams, Robertson. "The Numbers: What are the federal government's sources of revenue?" *Tax Policy Center,* http://www.taxpolicycenter.org/briefing-book/background/numbers/revenue.cfm
[39] ibid.

taxes have steadily fallen. Figure 7 below displays the proportion of Federal revenue from 1950 to 2010.

Figure 7: Sources of Federal Revenue, Fiscal Years 1950-2010

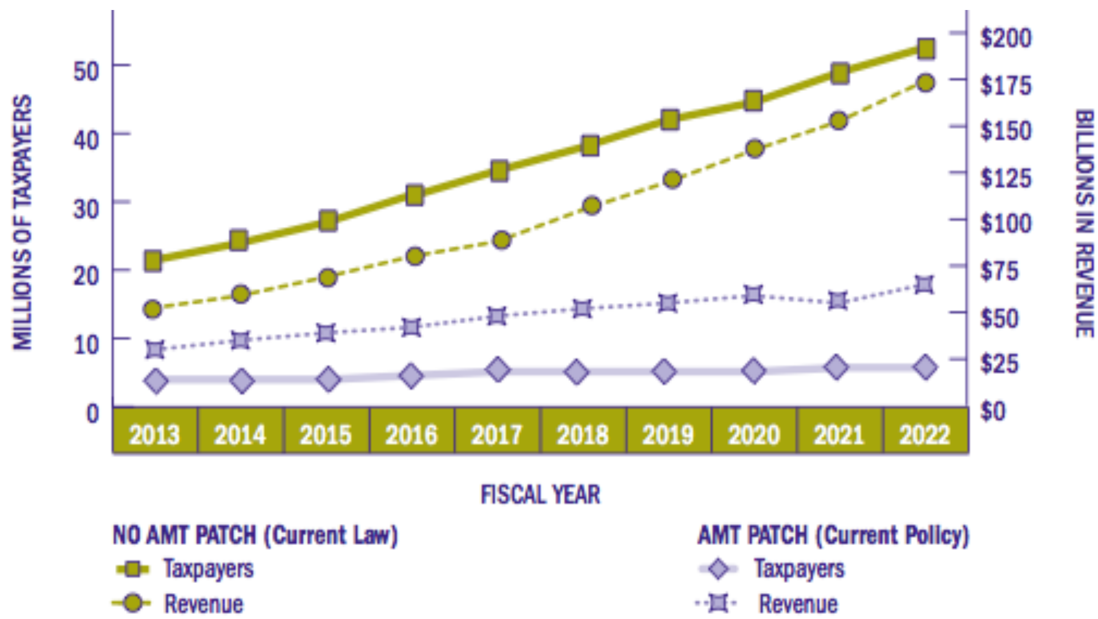


Source: Budget of the United States Government, Fiscal Year 2012, Historical Tables: Table 2.1; http://www.whitehouse.gov/omb/budget/Historicals

(Source: Tax Policy Center)

Now looking specifically at the Alternative Minimum Tax, the reach it has on the American taxpayers has been expanding over the years. In 2012, the AMT affected 30 percent of filers that itemized deductions. This is a much larger proportion of taxpayers than the original intention of only the wealthiest individuals who had been avoiding paying any income taxes at all. While the tax has been expected to raise $1.2 trillion from 2011-2022, the results have been much less that anticipated, with only $33 billion being raised in both 2010 and 2011.[40] Figure 8 shows the anticipated revenues compared to number of taxpayers filing the AMT. Unfortunately for the U.S. government, in order to reach the projected revenues the patches made each year to prevent the tax from hitting a larger portion of taxpayers would not be able to continue, which is opposite of the purpose of the tax. Overall, the AMT is not reaching expectations in terms of revenue, and much more total tax reform would be needed in order to do so.

Figure 8: Projections of AMT Revenue and Taxpayers Affected by AMT



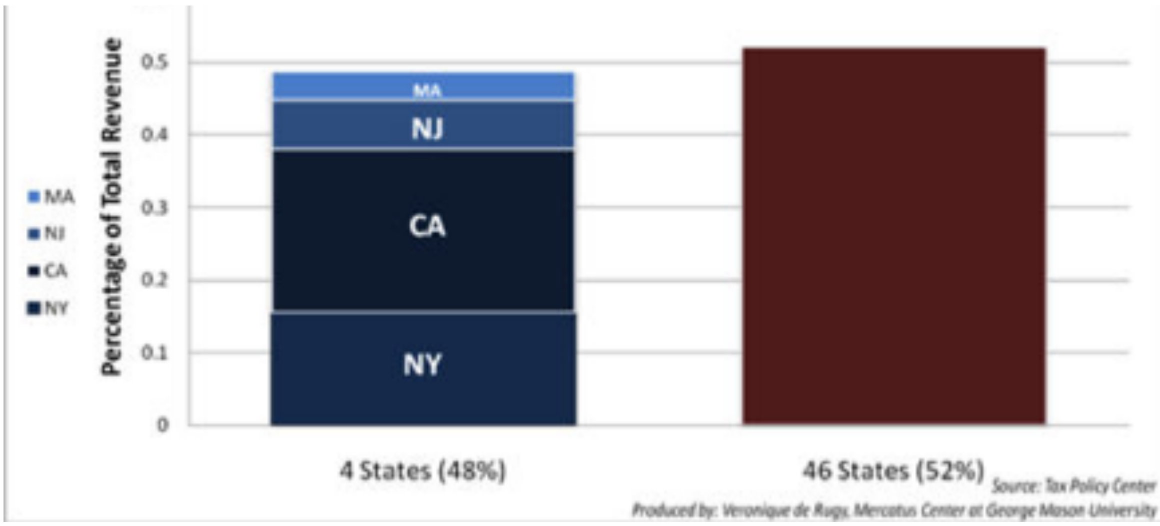
(Source: Taxpayers Advocate)

Another perspective of revenue generation is the amount generated by states. Since taxpayers living in high tax states are more likely to be subject to the AMT, it is expected that the majority of revenue would come from these states. As shown below in Figure 9 just under half (48%) of all AMT revenue comes from just 4 states; California, Massachusetts, New Jersey, and New York. California taxpayers made up the largest portion of AMT revenues with 22 percent of

[40] "The Alternative Minimum Tax Corrodes Both the Tax System and the Democratic Process", *Taxpayer Advocate Services,* http://www.taxpayeradvocate.irs.gov/userfiles/file/Full-Report/Most-Serious-Problems-Alternative-Minimum-Tax.pdf

the country's total, with New York coming in second with 16 percent. The disproportionate distribution of revenues displays the problem with disallowing state taxes as it disproportionately affects some while allowing others to avoid the AMT.

Figure 9: Comparison of AMT Revenue by State



(Source: Reason Foundation)

Analysis of Hypothetical Returns

The passage of the American Taxpayer Relief Act of 2012 was thought to have improved and "fixed" the AMT. In order to test this, hypothetical returns have been prepared for hypothetical taxpayers with varying demographics and income.

High-Tax State v. Low-Tax State

In order to display the discrepancy that identical taxpayers can face based on the state they live in, the returns have been prepared as though the taxpayer lives in California and again in Nevada. Additionally, all items are the same in each scenario with the exception of state and local taxes. For California residents, the amount included in the taxpayer's itemized deductions is state and local income taxes. For Nevada residents, this amount is general sales tax for itemized deductions. Finally, variations in property tax rates are disregarded in order to create identical taxpayers despite their geographic location. Below are the scenarios created for the 2012 tax year.

Scenario 1A: Single parent with two children, income of $200,000, living in California (high-tax state)

Calculate Regular Tax

Gross income	$200,000
Subtract deductions	
Itemized deduction	($55,695)
Personal exemptions	
(3 x $3,800)	($11,400)
Taxable income	$132,905
Tax bracket	23%
Tax before credits	**$30,674**

Calculate Tentative AMT

Taxable income	$144,305
Add preference items	
Taxes	$22,951
AMT income	$167,256
Subtract AMT exemption	
AMT exemption	($36,911)
Taxable under AMT	$130,345
AMT bracket	26%
Tax (tentative AMT)	**$33,890**

- **AMT = $3,216** ($33,890 – $30,674)

Scenario 1B: Single parent with two children, income of $200,000, living in Nevada (low-tax state)

Calculate Regular Tax

Gross income	$200,000
Subtract deductions	
Itemized deduction	($45,030)
Personal exemptions	
(3 x $3,800)	($11,400)
Taxable income	$143,570
Tax bracket	23%
Tax before credits	**$33,660**

Calculate Tentative AMT

Taxable income	$154,970
Add preference items	
Taxes	$12,286
AMT income	$167,256
Subtract AMT exemption	
AMT exemption	($36,911)
Taxable under AMT	$130,345
AMT bracket	26%
Tax (tentative AMT)	**$33,890**

- **AMT = $230** ($33,890 – $33,660)

Scenario 2A: Single parent with two children, income of $250,000, living in California (high-tax state)

Calculate Regular Tax

Gross income	$250,000
Subtract deductions	
Itemized deduction	($70,207)
Personal exemptions	
(3 x $3,800)	($11,400)
Taxable income	$168,393
Tax bracket	24%
Tax before credits	**$40,611**

Calculate Tentative AMT

Taxable income	$179,793
Add preference items	
Taxes	$29,527
AMT income	$209,320
Subtract AMT exemption	
AMT exemption	($26,395)
Taxable under AMT	$182,925
AMT bracket	28%
Tax (tentative AMT)	**$47,719**

- **AMT= $7,108** ($47,719 – $40,611)

Scenario 2B: Single parent with two children, income of $250,000, living in Nevada (low-tax state)

Calculate Regular Tax

Gross income	$250,000
Subtract deductions	
Itemized deduction	($55,566)
Personal exemptions	
(3 x $3,800)	($11,400)
Taxable income	$183,034
Tax bracket	25%
Tax before credits	**$44,929**

Calculate Tentative AMT

Taxable income	$194,434
Add preference items	
Taxes	$14,886
AMT income	$209,320
Subtract AMT exemption	
AMT exemption	($26,395)
Taxable under AMT	$182,925
AMT bracket	28%
Tax (tentative AMT)	**$47,719**

- **AMT= $2,790** ($47,719 – $44,929)

Scenario 3A: Single parent with two children, income of $400,000, living in California (high-tax state)

Calculate Regular Tax

Gross income	$400,000
Subtract deductions	
Itemized deduction	($114,727)
Personal exemptions	
(3 x $3,800)	($11,400)
Taxable income	$273,873
Tax bracket	27%
Tax before credits	**$74,906**

Calculate Tentative AMT

Taxable income	$285,273
Add preference items	
Taxes	$50,240
AMT income	$335,513
Subtract AMT exemption	
AMT exemption	$0
Taxable under AMT	$335,513
AMT bracket	28%
Tax (tentative AMT)	**$90,444**

- **AMT= $15,538** ($90,444 – $74,906)

Scenario 3B: Single parent with two children, income of $400,000, living in Nevada (low-tax state)

Calculate Regular Tax

Gross income	$400,000
Subtract deductions	
Itemized deduction	($87,173)
Personal exemptions	
(3 x $3,800)	($11,400)
Taxable income	$301,427
Tax bracket	28%
Tax before credits	**$83,999**

Calculate Tentative AMT

Taxable income	$312,827
Add preference items	
Taxes	$22,686
AMT income	$335,513
Subtract AMT exemption	
AMT exemption	$0
Taxable under AMT	$335,513
AMT bracket	28%
Tax (tentative AMT)	**$90,444**

- **AMT= $6,445** ($90,444 – $83,999)

Scenario 4A: Single parent with two children, income of $500,000, living in California (high-tax state)

Calculate Regular Tax

Gross income	$500,000
Subtract deductions	
Itemized deduction	($145,396)
Personal exemptions	
(3 x $3,800)	($11,400)
Taxable income	$343,204
Tax bracket	28%
Tax before credits	**$97,785**

Calculate Tentative AMT

Taxable income	$354,604
Add preference items	
Taxes	$65,037
AMT income	$419,641
Subtract AMT exemption	
AMT exemption	$0
Taxable under AMT	$419,641
AMT bracket	28%
Tax (tentative AMT)	**$113,999**

- **AMT= $16,214** ($113,999 – $97,785)

Scenario 4B: Single parent with two children, income of $500,000, living in Nevada (low-tax state)

Calculate Regular Tax

Gross income	$500,000
Subtract deductions	
Itemized deduction	($108,245)
Personal exemptions	
(3 x $3,800)	($11,400)
Taxable income	$380,355
Tax bracket	29%
Tax before credits	**$110,045**

Calculate Tentative AMT

Taxable income	$391,755
Add preference items	
Taxes	$27,886
AMT income	$419,641
Subtract AMT exemption	
AMT exemption	$0
Taxable under AMT	$419,641
AMT bracket	28%
Tax (tentative AMT)	**$113,999**

- **AMT= $3,954** ($113,999 – $110,045)

The following scenarios below (5A and 5B) use an income level of $318,000. This income level represents the mean household income for the top 5 percent of households in the United States according to the Census Bureau.[41]

Scenario 5A: Single parent with two children, income of $318,000, living in California (high-tax state)

Calculate Regular Tax

Gross income	$318,000
Subtract deductions	
Itemized deduction	($81,864)
Personal exemptions	
(3 x $3,800)	($11,400)
Taxable income	$224,736
Tax bracket	26%
Tax before credits	**$58,691**

Calculate Tentative AMT

Taxable income	$236,136
Add preference items	
Taxes	$37,217
AMT income	$273,353
Subtract AMT exemption	
AMT exemption	($10,387)
Taxable under AMT	$262,966
AMT bracket	28%
Tax (tentative AMT)	**$70,130**

- **AMT= $11,439** ($70,130 – $58,691)

Scenario 5B: Single parent with two children, income of $318,000, living in Nevada (low-tax state)

Calculate Regular Tax

Gross income	$318,000
Subtract deductions	
Itemized deduction	($60,833)
Personal exemptions	
(3 x $3,800)	($11,400)
Taxable income	$245,767
Tax bracket	27%
Tax before credits	**$65,631**

Calculate Tentative AMT

Taxable income	$257,167
Add preference items	
Taxes	$16,186
AMT income	$273,353
Subtract AMT exemption	
AMT exemption	($10,387)
Taxable under AMT	$262,966
AMT bracket	28%
Tax (tentative AMT)	**$70,130**

- **AMT= $4,499** ($70,130 – $65,631)

[41] Noss, Amanda. "Household Income: 2012." *United States Census Bureau.* (September 2013). Accessed January 15, 2015. http://www.census.gov/prod/2013pubs/acsbr12-02.pdf

In the following scenarios (6A and 6B), the number of children the taxpayer has been increased from two to four. This has been done to show the effect that additional dependants have on the AMT. As discussed previously in the paper, the higher the number of dependants, the higher the AMT will be. In this case, the AMT increases by $1,843 ($5,059 - $3,216) in the high-tax state and increases by $1,483 ($1,713 - $230) in the low-tax state.

Scenario 6A: Single parent with four children, income of $200,000, living in California (high-tax state)

Calculate Regular Tax

Gross income	$200,000
Subtract deductions	
Itemized deduction	($28,276)
Personal exemptions	
(5 x $3,800)	($19,000)
Taxable income	$152,724
Tax bracket	24%
Tax before credits	**$36,223**

Calculate Tentative AMT

Taxable income	$171,724
Add preference items	
State Taxes	$18,276
AMT income	$190,000
Subtract AMT exemption	
AMT exemption	($31,225)
Taxable under AMT	$158,775
AMT bracket	26%
Tax (tentative AMT)	**$41,282**

- **AMT= $5,059** ($41,282 – $36,223)

Scenario 6B: Single parent with four children, income of $200,000, living in Nevada (low-tax state)

Calculate Regular Tax

Gross income	$200,000
Subtract deductions	
Itemized deduction	($16,328)
Personal exemptions	
(5 x $3,800)	($19,000)
Taxable income	$164,672
Tax bracket	24%
Tax before credits	**$39,569**

Calculate Tentative AMT

Taxable income	$183,672
Add preference items	
State Taxes	$6,328
AMT income	$190,000
Subtract AMT exemption	
AMT exemption	($31,225)
Taxable under AMT	$158,775
AMT bracket	26%
Tax (tentative AMT)	**$41,282**

- **AMT= $1,713** ($41,282 – $39,569)

Table 4: Summary of Hypothetical Scenarios

Income Level	Number of Children	High-Tax State AMT (CA)	Low-Tax State AMT (NV)	Difference
$200,000	2	$3,216	$230	$2,986
$250,000	2	$7,108	$2,790	$4,318
$318,000	2	$11,439	$4,499	$6,940
$400,000	2	$15,538	$6,445	$9,093
$500,000	2	$16,214	$3,954	$12,260
$200,000	4	$5,059	$1,713	$3,346

As shown by each scenario, despite the inflation indexing that was implemented through the American Taxpayer Relief Act of 2012 (ATRA), taxpayers much below the initial goal of the top three percent of income earners are still falling victim to the AMT. As previously mentioned, the treatment of specific items such as state and local taxes and exemption amounts are the main causes as these are the only amounts to change in each scenario. The average additional amount owed by the resident living in the high-tax state is $6,491. An additional item to note is the change in AMT owed by the low-tax state residents with income of $400,000 and income of $500,000. With income of $400,000 the resident owed an AMT of $6,445, but the amount owed decreased with an increase in income. With income of $500,000 the AMT owed decreased by $2,491 to only $3,954, meaning that at this higher income level taxpayers are facing a less harsh AMT penalty. Again, this goes against the original intention of hitting high-income taxpayers. Overall, each scenario included, with the exception of the $500,000 income level are taxpayers who should not be facing an AMT liability at all. Unfortunately for these taxpayers, despite the passage of ATRA and attempt by Congress to “fix” this broken tax, there clearly is need for more alterations in order to truly repair the tax.

The Bare Minimum

The following scenarios remove the implications of state and local taxes as they apply to taxpayer's itemized deductions. For each of the following, the taxpayer's filing status is head of household and they opt to not itemize their deductions and simply use the standard deduction. They make a modest living, well below the bottom cutoff of the top five percent of $200,000 and do not own a home but rent instead.

Scenario 7A: Single parent with three children, income of $125,000, using only the standard deduction

Calculate Regular Tax

Gross income	$125,000
Subtract deductions	
Standard deduction	($8,700)
Personal exemptions	
(4 x $3,800)	($15,200)
Taxable income	$101,100
Tax bracket	20%
Tax before credits	**$19,920**

Calculate Tentative AMT

Taxable income	$125,000
Add preference items	
Taxes	$0
AMT income	$125,000
Subtract AMT exemption	
AMT exemption	($47,475)
Taxable under AMT	$77,525
AMT bracket	26%
Tax (tentative AMT)	**$20,157**

- **AMT= $237** ($20,157 – $19,920)

Scenario 7B: Single parent with four children, income of $90,000, using only the standard deduction

Calculate Regular Tax

Gross income	$90,000
Subtract deductions	
Standard deduction	($8,700)
Personal exemptions	
(5 x $3,800)	($19,000)
Taxable income	$62,300
Tax bracket	16%
Tax before credits	**$10,226**

Calculate Tentative AMT

Taxable income	$90,000
Add preference items	
Taxes	$0
AMT income	$90,000
Subtract AMT exemption	
AMT exemption	($50,600)
Taxable under AMT	$39,400
AMT bracket	26%
Tax (tentative AMT)	**$10,244**

- **AMT= $18** ($10,244 – $10,226)

While the amount of AMT liability faced by each of these taxpayers is not substantial, the mere fact that they are subjected to pay an AMT at all just provides another example of just how broken the tax is. By no means does an income of $90,000 or $125,000 depict a high-income individual regardless of the state they live in. These taxpayers also opt to use the standard deduction rather than itemizing, which theoretically should help reduce the likelihood of them being caught in the AMT. Finally, the inclusion of having one additional child increases the chances of being caught by the AMT and again shows the unfairness of the penalty taxpayers with many children face. This additional penalty faced by parents in unnecessary as the IRS has already instituted a "Kiddies Tax". This tax is meant to prevent parents from avoiding taxes by shifting unearned income to their children.[42] Overall any questions of the AMT's excessive capturing of unintended taxpayers are clearly answered with these middle-high income individuals facing even a single dollar of the AMT penalty.

Potential Solutions for Changing the AMT

In a Perfect World: Repeal the AMT

One of the most obvious solutions for the issues the AMT presents taxpayers is to eliminate it completely. The option to repeal the AMT has been discussed by multiple areas of the accounting community in recent years. In 1999, Congress voted to repeal the AMT, but the legislation was vetoed.[43] According to the IRS' Taxpayer Advocate Service 2012 report to Congress, they reiterate their continual suggestion to repeal the AMT. Additionally, the American Bar Association of Taxation, the American Institute of Certified Public Accountants

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[42] Ford, Allen, and Heidi L. Hydeman. "The Dreaded Kiddies Tax." *Journal of Accountancy.* (June 30, 2007). Accessed on February 5, 2015. http://www.journalofaccountancy.com/Issues/2007/Jul/TheDreadedKiddieTax.htm

[43] "The Alternative Minimum Tax Corrodes Both the Tax System and the Democratic Process", *Taxpayer Advocate Services,*

Tax Division, the Tax Executives Institute, and the National Association of Enrolled Agents have all advocated the repeal of the individual AMT.[44] In the words of former IRS taxpayer advocate Val Oveson, the AMT is, "absolutely, asininely stupid."[45] Unfortunately, despite the suggestions of such varied sources, a complete repeal of the individual AMT appears extremely unlikely.

Since the AMT generates some additional revenue for the government, it seems highly doubtful that the government would willingly dispose of a source of revenue. Not only would this remove a stream of revenue that would need to be replaced by a new source, it also means that the government's spending may need to be altered in order to account for a lack of inflow. According to the Congressional Budget Office, repealing the AMT would cost the government $620 billion in revenue over the next 10 years.[46] This decrease in revenues would only add to the current deficit, so it may be too late and too costly to completely repeal the AMT.

Outside of the political and economic arguments against the repeal of the AMT, is a reason the AMT may never be repealed. Unfortunately, many that are falling victim to the AMT that are outside of the original scope are taxpayers that do not have a voice in the argument. As noted in an interview with a tax professional, Mr. Ron Rangel, CPA noted that 45 percent of the returns he complete have an AMT liability although they would not fall in to thee category of "high-income" taxpayers.[47] As shown throughout this paper, the amount of taxpayers being captured and the demographics of those taxpayers show they are not in a place to make political arguments and thus they do not have a voice. Although one could make the argument that the high-income individuals falling victim could speak up for all AMT victims that is not likely to

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[44] ibid.
[45] Edwards, Chris. "The Alternative Minimum Tax: Repeal Not Reform." *Cato Institute.* No. 47. (May 2007). Accessed on January 20, 2015. http://www.cato.org/sites/cato.org/files/pubs/pdf/tbb_0507_45.pdf
[46] "The Individual Alternative Minimum Tax". *Congressional Budget Office.* (January 2010).
[47] R. Rangel. Personal Communication. February 5, 2015.

happen. This is because for many of these extremely wealthy individuals, any arguments against the AMT could promote change in other items such as capital gains tax and subject them to higher tax liabilities that they can escape simply by paying a bit higher AMT tax and just adds another point against AMT repeal.

The Realistic Option: Restructuring the AMT

Considering the unlikelihood that the AMT will be repealed any time soon, the decision to restructure the AMT is a much more viable option. A key option for restructuring would be to alter the treatment of T.I.M.M.E. items, especially state and local taxes. Seeing how a taxpayer can be severely penalized by additional thousands of dollars just for living in a high-tax state, an alteration must be made. A simple yet effective option regarding these adjustments would be to completely eliminate them from the AMT. By doing so this would help lessen the burden those in high-tax states face. Additionally, it could help make the AMT a bit less complicated for those attempting to do their taxes themselves.

Another option for reform would be to adjust the AMT exemption amounts. The AMT exemption is included in order to help prevent taxpayers who should not be caught by the AMT from having to pay any additional amount due to the AMT. In order to guarantee that this is being accomplished, the exemption for everyone, depending on filing status, should be increased to an amount so that no one below a “high-income” level will pay a cent. The task of setting what income level is considered “high” is up for debate and may never truly be decided. A starting point for AMT reform could come from the recent Obamacare Medicare tax increases. The Obamacare Medicare Tax is said to apply to high-income taxpayers, dependent on their income levels. According to this legislation, “high-income” is considered to be AGI of $200,000 for single filers, $250,000 for married filing jointly, and $125,000 for married filing separately.[48] Having AMT exemption amounts set to these levels would prevent any taxpayer below this income level from facing the AMT, and thus creates a starting place for AMT reform.

A Final Scenario: The Under 24 Issue

After considering the variety of options available for either the repeal or reform of the AMT, there is sure to still be critics that would veto any mention of a change to the tax. People may consider that $200,000 of income is high enough income to deserve an additional tax liability and that the AMT is taxing people fairly. To truly address the fairness of this tax let's analyze one final scenario.

Suppose there is an 18 year-old student, Johnny Unlucky, and he recently lost his father. Luckily for Johnny his dad left behind an IRA that he is able to withdraw from to help him pay for his college education and expenses as he is beginning his first of four years at a university. Let's assume that Johnny withdraws $14,500 to pay for his tuition and such over the course of the year, the average income of persons age 15 to 24 in 2012 according to the U.S. Census Bureau.[49] As seen in Appendix A, Johnny unfortunately falls victim to the AMT. Without the AMT, he would only owe $478 in taxes, but due to the unfairness of the AMT he must pay an additional $1,485 for a total tax liability of $1,963.

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[48] Magister, Holly. "Obamacare Medicare Taxes- Increasing Your 2013 tax Bill." *Forbes.* Accessed on January 15, 2015. http://www.forbes.com/sites/hollymagister/2013/12/19/obamacare-medicare-taxes-increasing-your-2013-tax-bill/

[49] "Table P-10. Age—People (Both Sexes Combined) by Median and Mean" *United States Census Bureau.* Accessed January 15, 2015. http://www.census.gov/hhes/www/income/data/historical/household/census

Scenario 8A: Johnny Unlucky, income of $14,500

Calculate Regular Tax

Gross income	$14,500
Subtract deductions	
Standard deduction	($5,950)
Personal exemptions	
(1 x $3,800)	($3,800)
Taxable income	$4,750
Tax bracket	10%
Tax before credits	**$478**

Calculate Tentative AMT

Taxable income	$14,500
Add preference items	
State Taxes	$0
AMT income	$14,500
Subtract AMT exemption	
AMT exemption	($6,950)
Taxable under AMT	$7,550
AMT bracket	26%
Tax (tentative AMT)	**$1,963**

- **AMT= $1,485** ($1,963 – $478)

Now, for those that may feel an income of $14,500 is a bit high for a college freshman, let's consider another scenario involving Johnny. Consider the same circumstances, only this time Johnny withdraws $7,000 as income from his late father's IRA to pay for his college expenses. Unfortunately for Johnny he still is subject to an AMT liability. Under the regular tax calculation, he would not owe a cent of tax. Under the AMT, he must still pay $13 of AMT tax. His tax return Form 1040 and Form 6251 can be seen in Appendix B. Unless Johnny had income of $6,950 or less, he will be subject to the AMT no matter what due to his age and the fact that the income is not earned wages.

Scenario 8B: Johnny Unlucky, income of $7,000

Calculate Regular Tax

Gross income	$7,000
Subtract deductions	
Standard deduction	($5,950)
Personal exemptions	
(1 x $3,800)	($3,800)
Taxable income	$0
Tax bracket	10%
Tax before credits	**$0**

Calculate Tentative AMT

Taxable income	$7,000
Add preference items	
State Taxes	$0
AMT income	$7,000
Subtract AMT exemption	
AMT exemption	($6,950)
Taxable under AMT	$50
AMT bracket	26%
Tax (tentative AMT)	**$13**

- **AMT= $13 ($13 – $0)**

Unfortunately, Johnny faces the issue of being a part of "certain children under age 24". This means that his AMT exemption amount is limited to $6,950 plus any earned income, but since he does not have any earned income it is limited to $6,950. According to the IRS' instructions for the AMT your exemption is limited to the amount of earned income plus $6,950 if, "(1) You were under age 18 at the end of 2012, (2) You were age 18 at the end of 2012 and did not have earned income that was more than half of your support, or (3) You were a full-time student over age 18 and under age 24 at the end of 2012 and did not have earned income that was more than half of your support."[50] Since Johnny falls into this category, it forces him to pay a tax liability he would usually not be subjected to without the AMT.

These two scenarios involving Johnny are a tragic example of just how unfair and broken the individual AMT is. Not only is it subjecting taxpayers to higher tax liabilities, but forcing those who should not be facing consequences of the system to pay up when they should not need to. These examples make it clear alterations must be made in order to protect innocent taxpayers from facing the AMT.

Future Considerations

Seeing as the tax code is and should be an evolving system, there are opportunities for future research regarding the AMT. One could investigate deeper into the effects to ATRA in later years as tax statistics become readily available. Also, a comparison between previous years and the post-ATRA era could be done to see if ATRA did in fact prevent taxpayers from being hit by the AMT. Additionally, there could be an entirely new perspective and arguments made if the AMT is looked at from a much more economic angle. This could include topics such as the

[50] "Instructions for Form 6251." *Internal Revenue Service.* Accessed on January 20, 2015. http://www.irs.gov/pub/irs-prior/i6251--2012.pdf

income inequality issue in the United States and how that has caused a skew in the tax system. An example of this is simply the definition of "high-income" taxpayers and how this has changed over the years, from the AMT being created over those with $200,000 in income and now the income cutoff for the top 5 percent of households in the country being only $191,000 in 2012.[51] Overall, there are a large variety of paths that the AMT could be explored each lending to a discussion of a new layer of the problem it creates.

Conclusion

The individual Alternative Minimum Tax was originally created to ensure that the wealthiest in this country could not avoid paying their fair share, just as the average citizen must do. While the idea of a tax solely for those high-income individuals is a noble one, the institution of such a tax has been straying away from its original intention and spiraling out of control ever since its creation. The ones forced to pay the price for this failure of the tax system are the thousands of taxpayers subjected to this additional tax each year. With AMT capturing more and more taxpayers each year, the need for reform is pressing. The passage of ATRA was thought to have been the "fix" to all of the AMT problems, but now, two years later and the AMT is still failing. The AMT will continue to unfairly capture taxpayers and force them to pay higher tax liabilities unless Congress takes action and finally rights the wrong that they created and have failed to correct over the last 46 years.

[51] "Table H-1. Income Limits for Each Fifth and Top 5 percent" *United States Census Bureau.* Accessed January 15, 2015. http://www.census.gov/hhes/www/income/data/historical/household/

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Appendix A:

Johnny Unlucky $14,500 in income (Forms 1040 and 6251)

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Appendix B:

Johnny Unlucky $7,000 in income (Forms 1040 and 6251)

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