

**Written Statement of Nina E. Olson
National Taxpayer Advocate**

Before the

**Subcommittee on Select Revenue Measures
Committee on Ways and Means
U.S. House of Representatives**

On

The Alternative Minimum Tax

March 7, 2007

Mr. Chairman, Ranking Member English, and distinguished Members of the Subcommittee:

Thank you for inviting me to testify today about the Alternative Minimum Tax (AMT) for individuals taxpayers.¹ In my 2006 Annual Report to Congress, I designated the AMT as the most serious problem facing taxpayers and recommended that it be repealed.² Indeed, if I were given the opportunity to make just one change to the Internal Revenue Code, I would use it to eliminate the individual AMT.³

Why? Because the AMT is frustrating for taxpayers and bad for the tax system. It is frustrating for taxpayers for many reasons, including the difficulty in determining whether one is subject to the AMT, the difficulty in computing the AMT, the inaccurate and off-putting implication that the AMT applies because the taxpayer has escaped his or her rightful tax obligations by engaging in tax-avoidance techniques, and the fact that otherwise compliant taxpayers are often subject to penalties for failure to pay enough estimated tax during the year when they didn't properly anticipate their AMT liabilities.

The AMT is bad for the tax system because the disillusionment felt by taxpayers subject to the tax can erode their willingness to comply in the future. Moreover, the AMT negates the effect of tax rates and other tax provisions that apply under the regular tax rules and almost invisibly alters the distribution of the tax burden that exists under the regular tax system.

In my testimony today, I will provide an overview of the AMT, describe its history, explain how it is computed, and detail its key deficiencies. I will also provide several examples to show how it operates.⁴

¹ The views expressed herein are solely those of the National Taxpayer Advocate. The National Taxpayer Advocate is appointed by the Secretary of the Treasury and reports to the Commissioner of Internal Revenue. The statute establishing the position directs the National Taxpayer Advocate to present an independent taxpayer perspective that does not necessarily reflect the position of the IRS, the Treasury Department, or the Office of Management and Budget. Accordingly, Congressional testimony requested from the National Taxpayer Advocate is not submitted to the IRS, the Treasury Department, or the Office of Management and Budget for prior approval. However, we have provided courtesy copies of this statement to both the IRS and the Treasury Department in advance of this hearing.

² I have highlighted problems with the AMT in prior reports as well. In my 2001 Annual Report to Congress, I recommended that the AMT be repealed or, at a minimum, substantially revamped to accomplish its original objective of preventing high-income taxpayers from escaping taxation through the use of tax-avoidance techniques. National Taxpayer Advocate 2001 Annual Report to Congress 166-177. In my 2003 Annual Report to Congress, I designated the AMT as the most serious problem facing taxpayers. National Taxpayer Advocate 2003 Annual Report to Congress 5-19. In my 2004 Annual Report to Congress, I reiterated my recommendation that the AMT be repealed. National Taxpayer Advocate 2004 Annual Report to Congress 383-385.

³ As a matter of fairness, the repeal of the AMT would require that Congress address the treatment of unused prior-year minimum tax credits, perhaps simply by retaining section 53 of the Code.

⁴ The Taxpayer Advocate Service does not possess a revenue-estimating function. When we have written about the AMT in the past, we have generally used data developed by the Treasury Department's

Overview

The AMT was originally designed to prevent wealthy taxpayers from using tax shelters to avoid paying their fair share of taxes. However, Congress has changed the tax laws many times since the inception of the AMT and shut down many of the tax-avoidance opportunities that existed in the 1960s and 1970s. Today, the AMT affects millions of taxpayers with no tax-avoidance motives at all – unless one considers choosing to live in a high-tax state or choosing to have children to be a tax-avoidance motive. For 2004, the Treasury Department found that fully 68 percent of aggregate AMT tax preference dollars were attributable to the disallowance of the state and local tax deduction and 19 percent of aggregate AMT tax preference dollars were attributable to the disallowance of personal exemptions.⁵ Thus, about 87 percent of the additional income subject to tax under the AMT results simply because of taxpayers' place of residence or family composition.

Moreover, the AMT is now affecting increasing numbers of middle-income taxpayers, because the amount of income exempt from the AMT (the AMT "exemption amount") is not indexed for inflation. When Congress first enacted a minimum tax in 1969, the exemption amount was \$30,000 for all taxpayers. If Congress had indexed that amount, it would be equal to about \$165,000 today.⁶ Instead, the exemption amounts, after temporary increases that expired at the end of 2006, are \$45,000 for married taxpayers and \$33,750 for most other taxpayers.⁷ As a result, it is now projected that in 2007, absent a change in law, 23.4 million individual taxpayers – or about 26 percent of individual filers who pay income tax – will be subject to the AMT.⁸ Among the

Office of Tax Analysis, the Joint Committee on Taxation, or the Tax Policy Center, a joint venture of the Urban Institute and the Brookings Institution. Economists from each of these entities have told us that the modeling the others use is similar and generally produces similar results. Because the Tax Policy Center has published the most extensive data on the AMT, my testimony today generally cites to Tax Policy Center data.

⁵ Office of Tax Analysis, Department of the Treasury (unpublished tabulation), cited at http://www.taxpolicycenter.org/TaxFacts/TFDB/Content/PDF/amt_preference.pdf.

⁶ Department of Labor, Bureau of Labor Statistics, *Consumer Price Index – All Urban Consumers (CPI-U)* (as of Oct. 31, 2006). Congress acted after hearing testimony that 155 taxpayers with adjusted gross incomes above \$200,000 had paid no federal income tax for the 1966 tax year. See The 1969 Economic Report of the President: Hearings before the Joint Economic Comm., 91st Cong., pt. 1, p. 46 (1969) (statement of Joseph W. Barr, Secretary of the Treasury). The consumer price index has increased more than six fold since 1966, so the kinds of taxpayers who caught Congress' attention back then would be making over \$1.25 million today. See Department of Labor, Bureau of Labor Statistics, *Consumer Price Index – All Urban Consumers (CPI-U)* (as of Oct. 31, 2006). Yet the AMT today is not primarily affecting taxpayers with incomes over \$1.25 million. By 2010, it has been estimated that 82 percent of all taxpayers affected by the AMT will have incomes under \$200,000 – and 36 percent will have incomes under \$100,000. Greg Leiserson & Jeffrey Rohaly, *The Individual Alternative Minimum Tax: Historical Data and Projections* updated November 2006, table 5 (Nov. 10, 2006) (available at www.taxpolicycenter.org or on Lexis/Nexis at 2006 TNT 219-50).

⁷ IRC § 55(d).

⁸ Greg Leiserson & Jeffrey Rohaly, *The Individual Alternative Minimum Tax: Historical Data and Projections* updated November 2006, table 1 (Nov. 10, 2006) (available at www.taxpolicycenter.org or on Lexis/Nexis at 2006 TNT 219-50).

categories of taxpayers hardest hit, 89 percent of married couples with adjusted gross incomes between \$75,000 and \$100,000 and two or more children will owe AMT.⁹

The burden that the AMT imposes is substantial. In dollar terms, it is estimated that each AMT taxpayer will owe, on average, an additional \$6,782 in tax in 2006.¹⁰ In terms of complexity and time, taxpayers often must complete a 16-line worksheet,¹¹ read ten pages of instructions,¹² and complete a 55-line form¹³ simply to determine whether they are subject to the AMT. Thus, it is hardly surprising that 77 percent of AMT taxpayers hire practitioners to prepare their returns.¹⁴

Perhaps most disturbingly, it is often very difficult for taxpayers to determine in advance whether they will be hit by the AMT. As a result, many taxpayers are unaware that the AMT applies to them until they receive a notice from the IRS, and some discover they have AMT liabilities that they did not anticipate and cannot pay. To make matters worse, the difficulty of projecting AMT tax liability in advance makes it challenging for taxpayers to compute and make required estimated tax payments, which often results in these taxpayers being subject to penalties.

At some point very soon, by one estimate as early as in 2007, *we will reach a point where it will cost more for Congress to repeal the AMT than to repeal the regular tax and leave the AMT intact.*¹⁵ In a very real sense, then, the AMT is ceasing to fulfill its intended mission to prevent tax avoidance by the wealthy and is instead becoming the *de facto* tax system for millions of Americans. The obvious challenge in repealing the AMT is that its increasing revenue stream has been built into revenue estimates, so if it is repealed, either Congress will have to raise tax receipts in other ways or budget deficits will balloon. These alternatives admittedly are not appealing, but I have no

⁹ Greg Leiserson & Jeffrey Rohaly, *The Individual Alternative Minimum Tax: Historical Data and Projections* updated November 2006, table 3 (Nov. 10, 2006) (available at www.taxpolicycenter.org or on Lexis/Nexis at 2006 TNT 219-50).

¹⁰ Greg Leiserson & Jeffrey Rohaly, *The Individual Alternative Minimum Tax: Historical Data and Projections* updated November 2006, table 4 (Nov. 10, 2006) (available at www.taxpolicycenter.org or on Lexis/Nexis at 2006 TNT 219-50).

¹¹ IRS Form 1040, *Individual Income Tax Return*, Instructions at 39 (2006).

¹² IRS Form 6251, *Alternative Minimum Tax – Individuals*, Instructions (2006).

¹³ IRS Form 6251, *Alternative Minimum Tax – Individuals* (2006).

¹⁴ IRS Compliance Data Warehouse, *Individual Returns Transaction File (IRTF)*, Tax Year 2004.

¹⁵ Because of differing assumptions, estimates of when this crossover point will occur vary. The most recent modeling by the Tax Policy Center (TPC), a joint venture of the Urban Institute and the Brookings Institution, projects it will occur in 2007. Greg Leiserson & Jeffrey Rohaly, *The Individual Alternative Minimum Tax: Historical Data and Projections* updated November 2006, at 4 (Nov. 10, 2006) (available at www.taxpolicycenter.org or on Lexis/Nexis at 2006 TNT 219-50). The Treasury Department is projecting the crossover will occur in 2013. Office of Tax Analysis, Department of the Treasury (unpublished tabulation). Based on our conversations with Treasury and TPC economists, we understand that the TPC model assumes that tax credits that can be used against the AMT, including the child tax credit and the earned income tax credit, would be repealed along with the regular income tax. The Treasury Department did not assume these credits would be repealed along with the regular income tax.

doubt there are solutions that are far preferable to the status quo. Significantly, the longer Congress waits to act, the more dependent the government will become on AMT revenue and the harder it therefore will become to repeal it.

While the concept of a minimum tax is not unreasonable, the AMT as currently structured has morphed into something that was never intended: It is penalizing taxpayers for such nontax-driven behavior as having children or selecting a state of residence; it is hitting taxpayers it was never intended to hit because its exemption amount has not been indexed for inflation; it is taking large numbers of taxpayers by surprise – and subjecting them to penalties to boot; it is imposing onerous compliance burdens; it is altering the distribution of the tax burden that exists under the regular tax system; it is changing the tax incentives built into the regular tax system; and it is neutralizing the effects of changes to tax rates imposed under the regular tax system.

Background of the AMT

The concept of a minimum tax was initially developed in response to reports that a small, wealthy group of taxpayers was avoiding taxes altogether through the use of tax avoidance techniques.¹⁶ In 1969, the House of Representatives adopted recommendations of the Treasury Department and passed a bill to impose a minimum tax by limiting certain tax preference items, in the aggregate, to 50 percent of gross income.¹⁷ This approach required the use of a complex formula designed to allocate itemized deductions between taxable income and non-taxable income and to disallow those deductions allocated to non-taxable income.¹⁸

The Senate changed the bill, adopting instead a tax on specified preference items in excess of a \$30,000 exemption amount.¹⁹ The final bill followed the Senate's approach and imposed an add-on tax of 10 percent on nine specific tax preference items when the sum of the preference items exceeded \$30,000.²⁰

The Tax Reform Act of 1976 and the Revenue Act of 1978 both made modifications to the add-on tax. The 1976 Act, among other things, increased the add-on tax rate to 15 percent and lowered the exemption amount from \$30,000 to the greater of \$10,000 or

¹⁶ *The 1969 Economic Report of the President: Hearings before the Joint Economic Comm.*, 91st Cong., pt. 1, p. 46 (1969) (statement of Joseph W. Barr, Secretary of the Treasury); Committee on Ways and Means of the U.S. House of Representatives and Committee on Finance of the U.S. Senate, 91st Cong., *Tax Reform Studies and Proposals*, U.S. Treasury Department, pt. 1, p. 132 (Comm. Print 1969).

¹⁷ H.R. 13270, § 301(a) (version passed by the House of Representatives on Aug. 8, 1969).

¹⁸ See H.R. Conf. Rep. No. 91-782, p. 301 (1969).

¹⁹ H.R. 13270 (substituted version passed by the Senate on Dec. 11, 1969).

²⁰ Tax Reform Act, Pub. L. No. 91-172, § 301 (1969). The nine specified tax preference items were (1) excess investment interest income, (2) accelerated depreciation on personal property, (3) accelerated depreciation on real property, (4) amortization of certified pollution control facilities, (5) amortization of railroad rolling stock, (6) tax benefits from stock options, (7) bad debt deductions of financial institutions, (8) depletion, and (9) the deduction for capital gains.

one-half of regular tax liability.²¹ The 1976 Act also added a new preference item for “excess itemized deductions” equal to the amount by which itemized deductions (other than medical and casualty deductions) exceeded 60 percent of adjusted gross income.²² The 1978 Act went a step further, restructuring the tax into two components. The add-on tax was retained for all tax preferences except the capital gains deduction and excess itemized deductions, and a new alternative minimum tax was established to adjust the taxpayer’s income for these two items of tax preference. This new alternative minimum tax (AMT) imposed a progressive three-tiered rate structure on AMT: 10 percent on AMT income between \$20,001 and \$60,000; 20 percent on AMT income between \$60,001 and \$100,000; and 25 percent on AMT income over \$100,000.²³

In 1982, Congress repealed the add-on tax but left the AMT intact.²⁴ Although Congress has enacted many technical changes over the past 25 years, the basic structure of the AMT rules has remained intact.

How the AMT Is Computed

The AMT’s method of calculation vividly demonstrates its complexity. The AMT requires a separate set of computations from the regular income tax, with unique rules governing the recognition of income and the timing of deductions and credits. Taxpayers are often required to maintain two sets of records – one for regular income tax purposes and one for AMT purposes.

The determination of AMT liability, if any, involves an eight-step process:

1. The taxpayer must calculate his regular tax liability. The regular income tax rules provide preferred treatment for certain types of income and allow taxpayers to claim certain exemptions, deductions, exclusions and credits.
2. The taxpayer must determine whether he is subject to additional tax under the AMT regime. The IRS provides a 16-line worksheet (Worksheet To See if You Should Fill in Form 6251 – Line 45)²⁵ to help taxpayers determine whether they may be subject to the AMT. If the worksheet indicates that a taxpayer is *potentially* subject to the AMT, the taxpayer must complete Form 6251 (Alternative Minimum Tax – Individuals), which contains 55 lines. Many taxpayers are required to complete Form 6251 – only to find that they do not have an AMT liability.
3. The taxpayer must compute his alternative minimum taxable income (AMTI) on Form 6251. This computation generally requires taxpayers to give up the benefit

²¹ Tax Reform Act, Pub. L. No. 94-455, § 301 (1976).

²² *Id.*

²³ Revenue Act, Pub. L. No. 95-600, § 421 (1978).

²⁴ Tax Equity and Fiscal Responsibility Act, Pub. L. No. 97-248, § 402(a) (1982).

²⁵ IRS Form 1040, *Individual Income Tax Return*, Instructions at 39 (2006).

of tax preference items to which they are entitled under the regular tax system (e.g., dependency exemptions, a standard deduction, and itemized deductions for state and local taxes, employee business expenses and legal fees).²⁶

4. The taxpayer must determine an “exemption amount” to which he is entitled based on filing status. After temporary increases in the AMT exemption amounts in recent years that have now expired, the AMT exemption amounts for 2007 stand at \$45,000 for married taxpayers and \$33,750 for most other taxpayers.²⁷ The exemption amounts are phased out for married taxpayers with AMTI exceeding \$150,000 and non-married taxpayers with AMTI exceeding \$112,500.²⁸
5. The taxpayer must compute his “taxable excess” by subtracting the exemption amount from his AMTI.
6. A taxpayer with a positive “taxable excess” must compute his “tentative minimum tax.” A “taxable excess” of \$175,000 or less is taxed at a 26 percent rate and any additional “taxable excess” is taxed at a 28 percent rate. The sum of the two amounts, minus the alternative minimum tax foreign tax credit, is the “tentative minimum tax.”²⁹
7. The taxpayer must compute his “alternative minimum tax” or “AMT.” The AMT is equal to the excess of the taxpayer’s tentative minimum tax, if any, over his regular tax liability (reduced by any tax from Form 4972 (Tax on Lump Sum Distributions) and any foreign tax credit from Form 1040). If the net result is a negative number or zero, the taxpayer does not owe AMT.
8. If the taxpayer owes AMT, he computes his tax liability by adding his regular tax liability and his AMT liability.³⁰

²⁶ Required adjustments listed on Form 6251 include adjustments for medical and dental expenses, state and local taxes, certain non-allowable home mortgage interest, miscellaneous itemized deductions, tax refunds, investment interest, depletion, certain net operating losses, interest from specified private activity bonds, qualified small business stock, the exercise of incentive stock options, estates and trusts, electing large partnerships, property dispositions, depreciation on certain assets, passive activities, loss limitations, circulation costs, long-term contracts, mining costs, research and experimental costs, income from pre-1987 installment sales, intangible drilling costs, certain other adjustments and alternative tax net operating loss deductions. See IRC §§ 56 and 57; IRS Form 6251 (Alternative Minimum Tax – Individuals), Part I.

²⁷ IRC § 55(d).

²⁸ IRC § 55(d)(3).

²⁹ IRC § 55(b)(1)(A).

³⁰ In many cases, the taxpayer’s final tax liability is simply the greater of his regular tax liability or his tentative minimum tax liability. But because the Code requires adjustments for credits and other taxes, the Seventh and Eighth steps are required to ensure that taxpayers with these tax items obtain the correct result.

A taxpayer's AMT liability may result in an AMT credit.³¹ In general, an AMT credit may be used in the future when the taxpayer's regular tax liability, reduced by other nonrefundable credits, exceeds the taxpayer's tentative minimum tax for the year.³² However, a taxpayer who owes AMT generates an AMT credit only to the extent the credit is caused by "deferral" items and not by "exclusion" items. Deferral items are those that are accounted for in different tax years in the regular tax and AMT systems. For example, the AMT in some instances requires taxpayers to depreciate property over a longer period of time. Exclusion items are adjustments and tax preference items that result in the permanent disallowance of certain tax benefits such as the standard deduction, personal exemptions and certain itemized deductions. Thus, many individual taxpayers who owe AMT will never be able to use an AMT credit.

Problems with the AMT

At the risk of some redundancy, the following is a concise list of some of the most significant problems relating to the AMT:

- Impact on "Wrong" Taxpayers. The AMT no longer targets just wealthy taxpayers engaged in tax avoidance. The number of AMT filers is projected to grow to 32.4 million by 2010.³³ Among taxpayers with incomes between \$100,000 and \$200,000, a staggering 80 percent will be subject to the AMT.³⁴ Even more notable, the AMT will affect a higher percentage of taxpayers with incomes between \$75,000 and \$100,000 (50 percent) than taxpayers making more than \$1 million (39 percent).³⁵
- Lack of AMT Knowledge. Taxpayers often file their returns not knowing about the AMT or expecting to be subject to it, but then receive bills relating to the AMT that they are not prepared to pay. In fiscal year 2005, the IRS closed more than 21,500 examinations that were initiated because of suspected AMT liabilities. These examinations resulted in additional tax assessments of nearly \$39 million – about \$1,700 per return.³⁶
- Complexity. The individual AMT computations are completely separate from the regular income tax computations. As described above, taxpayers may need to fill

³¹ IRC § 53.

³² Beginning in 2007, an individual with a long-term unused AMT credit may be able to use a portion of his AMT credit in a taxable year in which he, as a result of the tentative minimum tax limitation, otherwise could not use it. For 2007, a long-term unused AMT credit is an AMT credit that was generated before 2004. IRC § 53(e).

³³ Greg Leiserson & Jeffrey Rohaly, *The Individual Alternative Minimum Tax: Historical Data and Projections* updated November 2006, table 1 (Nov. 10, 2006) (available at www.taxpolicycenter.org or on Lexis/Nexis at 2006 TNT 219-50).

³⁴ *Id.* at table 3.

³⁵ *Id.* at table 3.

³⁶ IRS Wage & Investment Operating Division, Audit Information Management System (FY 2005 data).

out a 16-line worksheet and then a 55-line form (IRS Form 6251, Alternative Minimum Tax – Individuals) just to determine whether they are subject to AMT. Other complexities of the AMT include the re-computation of the foreign tax credit,³⁷ its effects on incentive stock options³⁸ and capital gains rates,³⁹ and the treatment of income of minor children (the so-called “kiddie tax”).⁴⁰

- Failure to Index AMT Exemptions for Inflation. Regular income tax standard deductions, exemptions and filing thresholds are all adjusted for inflation. As discussed above, however, the AMT exemption amounts are not. The absence of an AMT indexing provision is largely responsible for the increasing numbers of middle-class taxpayers who are subject to the AMT regime.⁴¹
- Adverse Impact on Families. Married taxpayers will be almost 15 times as likely as single taxpayers to pay AMT in 2007.⁴² One study projected that approximately 5.7 million taxpayers will pay AMT in 2010 simply because they lose the benefit of personal exemptions under the AMT.⁴³
- Loss of Itemized Deductions. An individual taxpayer must add back certain itemized deductions when computing the AMT.⁴⁴ This adjustment causes particular difficulties for taxpayers with large expenditures such as medical bills, legal fees in court settlements, state and local taxes, or employee business expenses.
- Unpredictability of Estimated Tax Payments. Because the law is so complicated, it is difficult, if not impossible, to predict whether an individual will be subject to the AMT. This uncertainty causes problems in paying the correct estimated tax for the year and can result in penalties for underpayment. In tax year 2004, for

³⁷ IRC § 59(a).

³⁸ IRC § 56(b)(3).

³⁹ IRC § 55(b)(3).

⁴⁰ IRC § 59(j).

⁴¹ The effect of the absence of AMT-exemption indexing is compounded by the fact that key tax preference items that are included in AMTI – e.g., the standard deduction and personal exemptions – are indexed annually.

⁴² Greg Leiserson & Jeffrey Rohaly, *The Individual Alternative Minimum Tax: Historical Data and Projections* updated November 2006, table 3 (Nov. 10, 2006) (available at www.taxpolicycenter.org or on Lexis/Nexis at 2006 TNT 219-50).

⁴³ Leonard E. Burman, William G. Gale & Jeffery Rohaly, *The AMT: Projections and Problems*, Tax Notes, July 7, 2003, pp. 105-106 (available at www.taxpolicycenter.org).

⁴⁴ IRC § 56(b) & (e). Common itemized deductions that must be added back to income include, but are not limited to, state and local taxes, real estate and personal property taxes, mortgage interest not used for the purchase or improvement of a personal residence, medical expenses exceeding 7.5 percent but less than 10 percent of adjusted gross income, and certain miscellaneous itemized deductions such as employee business expenses and legal fees.

example, 17.1 percent of AMT returns reported an estimated tax penalty on the return as compared with 3.7 percent of non-AMT returns.⁴⁵

- Taxation of Incentive Stock Options. A taxpayer's exercise of incentive stock options creates a paper (phantom) gain in the year the stock is purchased (*i.e.*, the option exercise). This gain is not taxed under the regular tax rules but is taxed for AMT purposes. The gain is the difference between the option price and the market value of the stock on the date the option is exercised to purchase the shares.
- Limitation on Availability of General Business Credits. Most general business tax credits are limited by the taxpayer's tentative minimum tax.⁴⁶ To illustrate, assume a taxpayer has a regular tax liability of \$10,000 prior to credits, tentative minimum tax of \$9,000, and a \$2,000 credit under IRC § 44 for constructing an access ramp to his business for disabled individuals. Absent the credit, the AMT has no effect on this taxpayer because his regular tax liability exceeds his tentative minimum tax. However, the disabled access credit would reduce the taxpayer's regular tax liability to \$8,000, which is below his tentative minimum tax. Therefore, the taxpayer is only entitled to a credit amount of \$1,000 and must carry back or carry forward the \$1,000 credit balance. Under these circumstances, the taxpayer is required to complete Form 6251 and attach it to his return – even though the taxpayer does not have an AMT liability – to substantiate his entitlement to a portion of the credit. The Treasury Department estimates that taxpayers will lose nearly \$13 billion in tax credits, mostly business credits, in 2010 because of the AMT.⁴⁷
- Timing Issues Resulting from AMT Tax Credit Regime. The portion of AMT attributable to timing items reflects the difference between when certain deductions are allowable under the AMT and when the same deductions are allowable under the regular income tax. The taxpayer can claim an AMT credit only in subsequent years when the regular tax exceeds the AMT.
- Requirement of Two Sets of Records. Taxpayers often must keep separate records for regular tax and AMT purposes. For example, assume a taxpayer placed an office building into service prior to 1999 and is claiming straight-line depreciation on the building. The taxpayer must depreciate the building over a 39-year period for regular tax purposes,⁴⁸ but for AMT purposes the depreciation period is 40 years.⁴⁹

⁴⁵ IRS Compliance Data Warehouse, Individual Returns Transaction File (IRTF), Tax Year 2004.

⁴⁶ IRC § 38(c)(1).

⁴⁷ Office of Tax Analysis, Department of the Treasury (unpublished tabulation); IRC § 55(c)(2).

⁴⁸ IRC § 168(c).

⁴⁹ IRC § 56(a)(1)(A)(i) (referencing IRC § 168(g)).

- Inconsistent Treatment of Carryover Items. When a taxpayer loses a tax benefit because of the AMT, the taxpayer may or may not be entitled to carry the benefit to another tax year, and the carryover periods vary from item to item. For example, an unused credit otherwise allowable for placing an alternative motor vehicle into service may not be carried over if the motor vehicle is not used in a trade or business.⁵⁰ Thus, if the vehicle is for personal use, any credit that cannot be used in the year in which the vehicle is placed into service is permanently lost. Unused general business credits, on the other hand, generally may be carried back one year and carried forward 20 years.⁵¹ By contrast, unused foreign tax credits generally may be carried back one year and carried forward ten years.⁵²
- Two Computations of Capital Gains Tax. Capital gains are taxed for regular tax purposes at lower rates than the AMT rates. Because Congress wanted to preserve tax-favored capital gains treatment under the AMT regime, a taxpayer with capital gains who owes AMT must complete 20 lines on Form 6251 after having already completed a Schedule D (Capital Gains and Losses) for regular tax purposes.
- Increased Use of Paid Preparers. Approximately 60 percent of taxpayers without AMT liabilities pay to have their returns prepared.⁵³ Where a taxpayer has an AMT liability, the use of paid preparers jumps to 77 percent.⁵⁴
- High AMT Marginal Tax Rates Due to Phase-out of AMT Exemption. As described above, the AMT rules impose tax at a rate of 26 percent on a “taxable excess” (*i.e.*, AMTI reduced by the applicable AMT exemption amount) up to \$175,000 and 28 percent on higher amounts. However, the AMT exemptions phase out at a 25 percent rate for married taxpayers with AMTI exceeding \$150,000 and non-married taxpayers with AMTI exceeding \$112,500.⁵⁵ Therefore, the AMT marginal tax rate can reach 35 percent.

Examples of AMT Impact

The following examples illustrate the impact of the AMT in four situations:⁵⁶

⁵⁰ A credit may be carried to another taxable year only if the Code expressly provides for it. In the case of the credit for alternative motor vehicles, carryovers are authorized only if the vehicle is used in a trade or business and is subject to depreciation. See IRC § 30B(g).

⁵¹ IRC § 39(a).

⁵² IRC § 904(c).

⁵³ IRS Compliance Data Warehouse, Individual Returns Transaction File (IRTF), Tax Year 2004.

⁵⁴ IRS Compliance Data Warehouse, Individual Returns Transaction File (IRTF), Tax Year 2004.

⁵⁵ IRC § 55(d)(3).

⁵⁶ These examples illustrate common AMT issues we have seen in the Taxpayer Advocate Service, but they do not represent the facts of any particular case.

AMT Penalty for Having Children: The (modified) Brady Bunch. Mr. and Mrs. Brady live in California in a rented home with their six children, ages 5-16. They claim the “married filing jointly” filing status and take the \$10,300 standard deduction in 2006. Mr. Brady, an architect, made \$73,160. Mrs. Brady worked part-time as a teacher and earned \$25,000. The Bradys owe \$2,424 in taxes under the regular tax system, but their tax bill rises to \$3,199 with the AMT because the tax benefits of the personal exemptions for their children are phased out under the AMT.

AMT Marriage Penalty. Assume the same facts as in the prior example except that Mr. and Mrs. Brady did not marry. If each used the “Head of Household” filing status and claimed their own three children, the AMT would not apply to either of them and their combined tax bill would be lower. Mrs. Brady would pay no tax and get \$4,500 in refundable credits (a \$2,385 EITC credit, a \$2,055 child tax credit, and a \$60 credit for federal telephone excise tax paid), and Mr. Brady would pay tax of \$5,404. Their combined tax liability would be \$904 (*i.e.*, \$5,404 minus \$4,500) – or \$2,295 less than their tax liability if they were married. Part of the difference in tax in these two examples is attributable to the general marriage penalty, but a significant portion is attributable solely to the AMT.

AMT Penalty for High State and Local Taxes. A taxpayer filed a joint return claiming two dependent children for 2006. The taxpayer had an adjusted gross income of \$190,000 and paid state income and property taxes totaling \$28,000. The taxpayer had 90 percent of his regular tax liability withheld from his paycheck. When the taxpayer prepared his return, he discovered that he had an additional tax liability of \$4,448 due to the AMT. Because of the additional AMT tax liability, he also owed a penalty for failure to pay estimated tax in the amount of \$210.

AMT Penalty Due to Combination of Having Children and Using “Married Filing Separately” Filing Status. A mother of five earned \$57,500 in 2006. She is seeking a legal separation from her husband and lived apart from him during the final months of the year and thus claimed “married filing separately” filing status. Because she was entitled to claim the children as her dependents and to claim the child tax credit, she had no tax liability under the regular tax rules. She therefore did not have any tax withheld from her paychecks. When she prepared her tax return, however, she discovered that she had a tax liability of \$1,909 due to the AMT. Because of the AMT tax liability, she also owed a penalty for failure to pay estimated tax in the amount of \$93.

Conclusion

To be viewed as fair, a tax system must be transparent. Yet the complexity of the AMT is such that many if not most taxpayers who owe the AMT do not realize it until they prepare their returns. It adds insult to injury when many of these taxpayers discover that they also owe a penalty for failure to pay sufficient estimated tax because they did not factor in the AMT when they computed their withholding exemptions or estimated tax payments. Taxpayers subjected to this treatment may wonder whether their

government is dealing fairly with them. To say the least, “gotcha” taxation is not good for taxpayers or the tax system.

Clearly, there are many practical, policy, and political challenges to repealing the individual AMT. But these challenges will continue to grow over time as the government, absent congressional action, becomes increasingly dependent on AMT revenue. With all the problems inherent in the AMT, I don’t think taxpayers will stand for it when the AMT begins to hit tens of millions of taxpayers within the next few years. The AMT is a time bomb, and it is set to detonate very soon. I strongly urge Congress to act before the AMT explosion.