

**BRIEF ANALYSIS**

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## The Alternative Minimum Tax Threatens Middle-Income Families

by Paul Dorasil

The Alternative Minimum Tax (AMT) enacted in 1978 was intended to tax the small number of wealthy individuals who, in any given year, legally owe no personal income tax due to the many exemptions allowed by the U.S. tax code. The AMT has its own set of rules, which limit deductions. Individuals with incomes above a certain level calculate their taxes under both sets of rules and pay whichever amount is higher.

However, the exemption levels are not indexed for inflation. Thus, as incomes have risen, more and more middle-class Americans have been forced to pay the AMT. Congress passed a temporary increase in the exempt amount, but it will expire next year, forcing millions of middle-income citizens to pay a tax intended only for the super-rich. Rather than creating another temporary fix, Congress should use this opportunity to permanently restructure the tax system.

**Temporary Solutions.** Congress has temporarily increased the level of adjusted gross income exempt from the AMT over the last several years. Specifically:

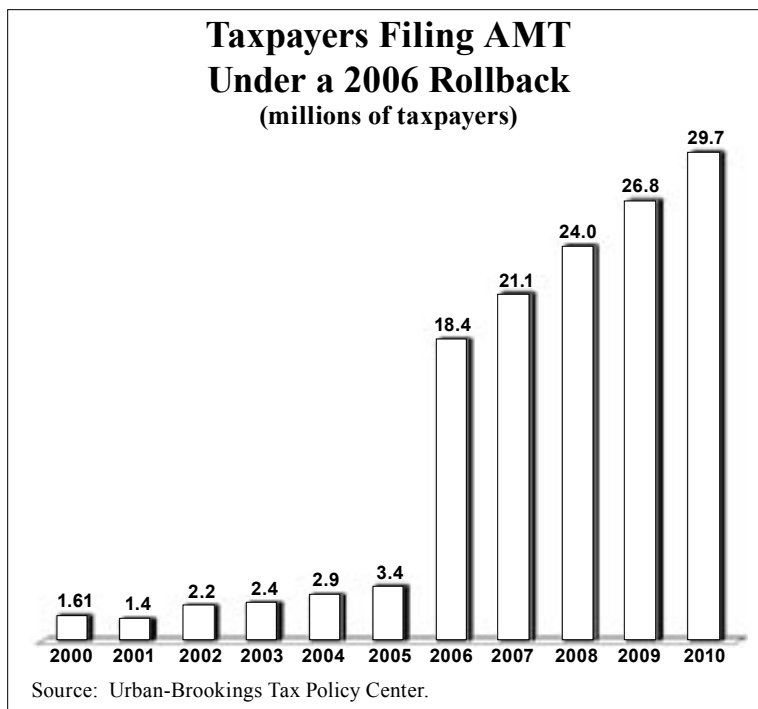
- As part of the 2001 Bush tax cuts, the exemption rose from \$33,750 to \$35,750 for single filers and from \$45,000 to \$49,000 for joint filers.

- In 2005, Congress raised the levels again to \$42,500 for single filers and to \$62,550 for joint filers.

But these increases are only temporary. In 2007, current AMT exemptions are scheduled to fall back to 2000 levels, substantially increasing taxes for millions of middle-class Americans. [See the figure.]

**Taxpayers Were Spared a Rollback in 2006.** According to the Urban-Brookings Tax Policy Center, if Congress had not raised the AMT exemptions in 2005 and allowed them to fall back to pre-2001 levels in 2006:

- More than one-in-five taxpayers (21.1 percent) would have filed under the AMT — up from only 4.1 percent in 2005.



- About 6.3 percent of filers with annual incomes between \$50,000 and \$75,000 would have filed under the AMT, up from only 0.3 percent in 2005.

- Almost 30 percent of filers between \$75,000 and \$100,000 would have been forced to file the AMT, up from 1.1 percent.

Additionally, the bulk of the costs would have fallen on middle-class, married taxpayers

with children:

- More than one-third of taxpayers with three or more children (34.5 percent) would file AMT, up from 8.3 percent in 2005, and 30 percent of married filers would file the AMT, up from 5.2 percent.
- Surprisingly, three-fourths of married couples with two children (73.4 percent) with incomes between \$75,000 and \$100,000 would have filed under the AMT, up from only 1.8 percent in 2005.

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If the existing temporary fix is allowed to expire in 2007 (as it will under current law), even more taxpayers will be affected by a rollback of the thresholds to 2000 levels.

**Problems with the AMT.** In addition to the burden that awaits middle-class families when the AMT extensions expire, there are other problems.

*Uncertainty for Taxpayers.* By continuously setting back the date when the 2000 exemption levels return, legislators create uncertainty in the economy. In any given year, if Congress cannot agree on legislation to temporarily extend higher exemption levels, the middle class will be hit by the AMT. Furthermore, should Congress allow a return to 2000 exemption levels, the complexity of the AMT creates uncertainty for individual tax filers as to how they will be affected. Thus, even in the years when Congress is successful in extending higher exemptions, middle-class taxpayers may reduce their investments in order to protect themselves against a possible future rollback.

*Future Dependence.* Because of the growing number of taxpayers filing the AMT every year, the federal budget will increasingly depend on it for tax revenue. Though repealing the AMT in 2006 will cost an average of \$74.5 billion annually over the next decade, if it remains in place, the costs increase over time. Every year after 2006, over two million more taxpayers will file AMT. By 2008, the AMT will be more expensive to repeal than the income tax — \$100 billion versus \$72 billion — according to the Tax Policy Center.

*Unfairness.* Currently, the AMT taxes individuals a flat 26 percent of gross income minus deductions for mortgage interest and charitable contributions. Therefore, the brunt of the AMT falls on taxpayers earning between \$200,000 and \$500,000. This is because they are most likely to fall under the AMT, but have lower mortgage interest and charitable deductions than higher-income taxpayers. While 43.4 percent of these individuals filed AMT in 2005, only 26.4 percent of taxpayers with incomes

of more than \$1,000,000 did, according to the Tax Policy Center. Ironically, the AMT does not achieve its original goal. Even with the AMT, 5,650 tax filers with incomes over \$200,000 owed no income taxes in 2002.

**Long-Term Solution.** The AMT is complex and ineffective in ensuring that the wealthy pay taxes on their incomes. But even if it were repealed this year (while leaving the rest of the income tax system in place), by 2010, over 9,000 high-income filers would pay zero income tax, due to exemptions.

Congress should create a system that taxes everyone fairly and efficiently, and simplifies the entire federal tax code. One solution is to replace the bloated, complex income tax system with a flat tax. For example, Congress could adopt a plan developed by NCPA President John C. Goodman with the help of economist Laurence Kotlikoff. Goodman proposes a 14 percent flat-rate tax that taxes the money people take out of the economy, not what they put into it. The Goodman plan can be structured in a way that:

- Ensures the rich continue to bear more of the burden than they currently do; thus, the plan can be more progressive than the current system.
- Taxes income only once (when it is earned), and does not tax savings or investments; thus, the plan promotes efficiency and economic growth.
- Does more to help low-income families by providing incentives to purchase health insurance and invest for retirement.

**Conclusion.** The AMT has not achieved its intended goals. It is inefficient because it discourages investment. At the same time, the AMT is ineffective in taxing the super-rich. Left unabated, it will cause a major tax increase for middle income filers starting in 2007. Congress could use this problem as an opportunity for real tax reform and adopt the Goodman plan for restructuring the federal tax code.

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