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## The Cost of Fixing the AMT Compared to Extending Capital Gains, Dividends & Marginal Rates

Since 2001, Congress has enacted a series of Alternative Minimum Tax (AMT) patches to index the AMT exemptions for inflation, thereby ensuring that the AMT does not partially undo the 2001 tax relief.<sup>1</sup> To continue this tax relief, Congress will need to pass another patch before the end of this year for tax returns which will be filed next spring. If Congress offsets AMT relief, taxes would have to be increased dramatically on taxpayers in all states and across most income brackets to benefit AMT taxpayers concentrated in high-income, high-tax states. Given the cost of an AMT patch (\$135 billion over two years), it is highly likely that Congress will have to waive the pay-as-you-go (paygo) budget rule in order to provide AMT relief in 2007.

Congress should continue its commitment to the fairest possible tax relief for all Americans by using this opportunity to extend the current treatment for capital gains, dividends and marginal rates rather than solely addressing the more limited and disproportionate AMT relief. Far more taxpayers benefit from these lower tax rates than would benefit from short-term AMT relief alone.

### THE ALTERNATIVE MINIMUM TAX

#### *Background*

The AMT was first enacted in 1969 after the press reported that 155 high-income Americans had not paid any federal income taxes in 1966.<sup>2</sup> In 1993, Congress set the AMT rates of 28 percent for taxpayers with annual income above \$175,000 and 26 percent for income below \$175,000.<sup>3</sup> From 1993 to 2005, the number of AMT filers

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<sup>1</sup> Julia A. Seymour, Business and Media Institute, *Media Amnesia Strikes on AMT Reform, AMT Mess: Media blame Bush tax cuts, not politicians who neglected to index the tax to inflation*, April 11, 2007.

<sup>2</sup> Senate Republican Policy Committee, "The Far-Reaching Tentacles of the Alternative Minimum Tax: A Glimpse at Past Legislation," April 17, 2007.

<sup>3</sup> *The Wall Street Journal*, "Bill Clinton's AMT Bomb," February 23, 2007.

grew from 300,000 to 4 million taxpayers due largely to the fact that Congress failed to index the exemption amounts for inflation.<sup>4</sup> Congress has enacted several “AMT patches” to hold many taxpayers harmless from the AMT on a year by year basis. Without a similar patch for 2007, some 23 to 26 million taxpayers will fall into the “AMT trap.”<sup>5</sup>

Democrats and Republicans alike agree that the AMT was never meant to apply to as many taxpayers as it will affect, without a patch, in 2007. For example, Senator Edward Kennedy has said: “The alternative minimum tax was never intended to apply to middle-class families, and they deserve tax relief.”<sup>6</sup> Senator Charles Grassley has echoed that sentiment, stating: “This tax was never meant to tax the middle class, so why should we count it as a revenue loss when we make sure they don’t have to pay it?”<sup>7</sup> Senator Grassley’s statement conveys the appropriate position that Americans should not have to endure a tax hike to “pay for” mistakes of Congresses past. These mistakes include raising the AMT’s tax rates and failing to index the AMT exemption for inflation.

### ***Who Pays the AMT?***

AMT taxpayers are predominately from states with high state and local taxes, including property taxes. The federal deduction for these taxes “lowers the taxpayer’s federal income tax...especially...in a high tax state” and pushes people into the AMT.<sup>8</sup> Therefore, high state tax rates largely determine who pays the AMT. According to 2005 data, the most recent available, most AMT filers earn between \$150,000 and \$500,000 and are located in high-income, high-tax states. Taxpayers in California, Connecticut, Maryland, New Jersey and New York collectively filed 24.2 percent of all returns that year but comprised 44.2 percent of all of the AMT returns.<sup>9</sup> As a result, an AMT fix will primarily benefit taxpayers in just a few states.

The following chart lists the ten states, and the District of Columbia, which had the highest percentage of AMT tax returns in 2005.<sup>10</sup> These are generally considered high-income, high-tax jurisdictions.

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<sup>4</sup> *The Wall Street Journal*. The AMT exemption amounts, which were set in 1993 but not indexed for inflation, were \$33,750 for individuals and \$45,000 for couples. The 2006 AMT patch raised the exemptions to \$42,500 for individuals and \$62,550 for couples for the 2006 tax year. Internal Revenue Service, Income Tax Returns, Preliminary Data, 2005. <http://www.irs.gov/pub/irs-soi/05inplim.pdf>.

<sup>5</sup> Senate Republican Policy Committee, “The Far-Reaching Tentacles of the Alternative Minimum Tax: A Glimpse at Past Legislation,” April 17, 2007.

<sup>6</sup> Senator Edward Kennedy, *Congressional Record*, February 13, 2006, as previously cited by the Senate Republican Policy Committee.

<sup>7</sup> *The Wall Street Journal*.

<sup>8</sup> The Tax Foundation, “Questions and Answers on the Alternative Minimum Tax,” July 21, 2007.

<sup>9</sup> The Tax Foundation. According to the Internal Revenue Service, taxpayers in California filed 4.86 percent of all AMT returns, Connecticut 5.90 percent, Maryland 5.02 percent, New Jersey 6.82 percent and New York 6.00 percent.

<sup>10</sup> The Tax Foundation. In addition, the District of Columbia is included in this list, though not a state.

Rank	State	Percent of Returns from State Subject to AMT	Additional Tax Liability per AMT Return
1	New Jersey	6.82%	\$4,065
2	New York	6.00%	\$5,370
3	Connecticut	5.90%	\$4,147
4	District of Columbia	5.19%	\$5,439
5	Maryland	5.02%	\$3,790
6	California	4.86%	\$5,079
7	Massachusetts	4.74%	\$4,049
8	Virginia	3.49%	\$3,486
9	Rhode Island	3.32%	\$3,952
10	Minnesota	3.04%	\$4,030
11	Oregon	2.94%	\$4,383

By contrast, the following chart lists the states with the lowest AMT burden.

Rank	State	Percent of Returns from State Subject to AMT	Additional Tax Liability per AMT Return
41	Indiana	1.42%	\$3,230
42	New Mexico	1.35%	\$3,829
43	Louisiana	1.27%	\$3,742
44	Wyoming	1.26%	\$5,858
45	West Virginia	1.14%	\$3,622
46	North Dakota	1.08%	\$2,765
47	Alabama	1.05%	\$4,246
48	Alaska	0.97%	\$4,031
49	Tennessee	0.96%	\$4,051
50	Mississippi	0.94%	\$3,389
51	South Dakota	0.87%	\$3,474

While these states have relatively fewer taxpayers paying AMT taxes, these taxpayers still have significant AMT liability. For example, the average Wyoming taxpayer paid \$5,858 more in taxes due to the AMT, which is an average AMT liability greater than that paid by taxpayers from California or New York.

### ***How Extensive is the AMT Problem?***

The number of taxpayers projected to pay the AMT in 2007, without a patch, is significantly higher than it was in 2005. In states like Connecticut, Maryland, and New Jersey, nearly 25 percent of all filers would be forced to pay the AMT.<sup>11</sup> New York alone would see an increase of nearly 1 million AMT taxpayers this year compared to last and the number of AMT taxpayers from California would increase by nearly

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<sup>11</sup> Institute on Taxation and Economic Policy Tax Model, "Taxpayers Likely to Pay the AMT in Tax Year 2007 Under Current Law, By State," April 2007.

1.7 million.<sup>12</sup> For many low-tax states, the percentage of taxpayers who would be forced to pay the AMT in 2007 would rise to somewhere between 9 and 12 percent of all returns.<sup>13</sup>

The AMT-impact on taxpayers in high-tax states will be significant if Congress fails to enact AMT relief. Many taxpayers will owe AMT taxes and, possibly, penalties and interest due to the underpayment of estimated quarterly taxes. Given the timing and stealth nature of the AMT, individual taxpayers will begin to feel the AMT impact early next year when they begin to prepare their 2007 tax returns.

## **COST OF AMT FIX VERSUS OTHER TAX EXTENDERS**

There are many options Congress can consider to address the AMT this year. The following chart contains information relative to various AMT options.<sup>14</sup>

<b>Proposal</b>	<b>Score</b>	<b>Tax Years</b>	<b>Taxpayers Benefiting</b>
Temporary AMT Patch	1 year \$50 billion 2 years \$135 billion	2007 2007-2008	19 million in 2007
AMT Patch Permanently Indexed for Inflation	\$523 billion	10 years	Estimate Not Available
Permanent AMT Repeal	\$872 billion	10 years	23 million in 2007

As in past years, Congress could enact a short term AMT patch to keep the number of AMT filers constant at about 4 million. The cost of such a patch will be about \$50 billion in 2007 and \$135 billion for 2007 and 2008. Another proposal, to enact an AMT patch permanently indexed for inflation, will cost nearly \$523 billion over 10 years. Congress could also permanently repeal the AMT at a cost of \$872 billion.

### ***Cost of Other Tax Extenders***

On December 31, 2010, the current tax rates on ordinary income, capital gains and dividends (along with other tax provisions) will expire. Congress will be faced with the decision of extending these tax rates, making them permanent or allowing them to expire. The following chart provides information regarding the cost of various tax extender proposals.

<sup>12</sup> Michael Franc, *Charlie Rangel's Dilemma over the AMT*, The Heritage Foundation, November 18, 2006.

<sup>13</sup> Institute on Taxation and Economic Policy Tax Model.

<sup>14</sup> Senate Committee on Finance, *Estimated Revenue Effects of Various Extender Options Fiscal Year 2008 through 2017*, September 11, 2007. Congressional Budget Office, *Budget Options*, February 2007.

<b>Proposal</b>	<b>Score</b>	<b>Tax Years</b>	<b>Taxpayers Benefiting<sup>15</sup></b>
Permanent Extension of Income Tax Rates	\$852 billion	10 years	At least 90.6 million
Temporary Extension of Income Tax Rates	1 year \$82 billion 2 years \$203 billion	2011 2011-2012	At least 90.6 million
Permanent Extension of Cap Gains & Dividends	\$216 billion	10 years	31 million returns reported dividend income and 26 million reported capital gains income
Temporary Extension of Cap Gains & Dividends	\$50 billion	2011-2012	31 million returns reported dividend income and 26 million reported capital gains income
Permanent Repeal of the Death Tax	\$367 billion	10 years	Estimate Not Available <sup>16</sup>

By comparison, the cost to permanently extend the current ordinary income tax rates (\$852 billion) is less than the cost of permanent AMT repeal (\$872 billion) and it benefits nearly four times as many taxpayers. The cost of a two-year AMT fix (\$132 billion) compares favorably to extending both the current ordinary income rates for an additional year (\$82 billion) and the current capital gains and dividend rates for two years (\$50 billion), but the latter would benefit over 90 million taxpayers.

Congress could also make capital gains and dividend tax treatment permanent (\$216 billion) and enact permanent death tax reform (\$367 billion) for roughly the same cost of enacting an AMT patch that is permanently indexed for inflation (\$523 billion).

## **WHO BENEFITS FROM LOWER TAX RATES?**

Americans filed nearly 135 million tax returns in 2005, of which 90.6 million reported income tax liability. Each taxpayer who filed one of these returns benefited from lower income tax rates, including 31 million filers (23 percent of all returns) with dividend income and 26 million filers (19 percent of all returns) with capital gains

<sup>15</sup> The 90.6 million taxpayers benefiting from reduced income tax rates does not include the 5 million families who were removed from the tax rolls and no longer pay income taxes. The capital gains and dividend beneficiaries are based on 2005 tax data.

<sup>16</sup> This proposal assumes a \$5 million estate exemption, a 15 percent rate up to \$25 million, and a 30 percent rate over \$25 million. This proposal would leave 5,600 estates with death tax liability in 2012 (down from the 62,000 estates under current law).

income.<sup>17</sup> The average combined income from capital gains and dividends across the country was \$5,841 per return in 2005.<sup>18</sup> By comparison, only 4 million taxpayers (3.01 percent of all returns) paid AMT taxes in 2005, with an average AMT liability of \$4,246 per return.

In 2005, taxpayers across the board benefited from lower income tax rates, including families, small businesses and senior citizens.<sup>19</sup> Of the 31 million returns with dividend income, 91 percent (28.2 million returns) were filed by people with income less than \$200,000 and 72 percent (22.4 million returns) were filed by people with income less than \$100,000.<sup>20</sup> This demonstrates that cutting taxes on investment income is not, as some have suggested, a tax cut “just for the rich.”

If Congress “pays for” an AMT fix by raising taxes on investment income, far more taxpayers would see their taxes increase than would benefit from an AMT fix. This is true for states like South Dakota where, under current law, nearly twice as many South Dakotans benefit from the low tax rate on capital gains and dividends than would pay the AMT in 2007 if Congress did nothing.<sup>21</sup> This is also true in Montana where, by over a two to one margin, more taxpayers would experience a tax hike than would benefit from an AMT fix which is paid for by raising taxes on capital gains and dividends.<sup>22</sup>

The same does not hold true in high-tax, high-income states like New Jersey. If Congress fails to enact an AMT fix this year, 25 percent of New Jersey taxpayers would pay AMT taxes. By comparison, 30 percent of returns from New Jersey claimed dividend income in 2005. As a result, the ratio of New Jersey taxpayers who could experience a tax increase compared to those benefiting from an AMT fix is about 1 to 1.

As current tax data demonstrates, the AMT will affect more and more taxpayers in the coming years, predominately in high-tax, high-income states. Republicans have rightly pursued legislation to protect taxpayers from the AMT. However, a partial repeal of the AMT, paid for with an increase in taxes elsewhere, would result in a tax increase for far more Americans than would be helped by any short-term AMT relief.

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<sup>17</sup> Internal Revenue Service, Individual Income Tax Returns, Preliminary Data, 2005.

<sup>18</sup> Tax Foundation, “As Presidential Candidates Target Investment Income for Higher Taxes, Which States Stand to Lose the Most?” July 16, 2007.

<sup>19</sup> Tax Foundation, “Majority of Seniors Benefit from Reduced Capital Gains and Dividend Tax Rates,” December 6, 2005. In 2004 a majority of taxpayers over the age of 65 earned dividend income. Tax Foundation, “The Importance of Dividend Income for Low-Income Seniors,” February 8, 2006.

<sup>20</sup> Individual Income Tax Returns. Of the \$153.7 billion in dividend income claimed in 2005, 48 percent was earned by people with income below \$200,000 and 31 percent by those with income below \$100,000.

<sup>21</sup> Internal Revenue Service Statistics of Income Data, 2005 Tax Year. Tax Foundation, Presidential Candidates. In 2007, nearly 11 percent of all South Dakota taxpayers would pay the AMT if Congress fails to act, which is far less than the number of taxpayers who claimed capital gains income (23.6 percent) and dividend income (24 percent) in 2005 (for an average combined income of \$4,306 per return).

<sup>22</sup> In Montana, the number of AMT filers would increase from 1.81 percent to 11 percent from 2005 to 2007 if Congress does not act. In 2005, 25.9 percent of Montana’s filers claimed dividend income and 24 percent claimed capital gains income.

## **CONCLUSION**

Far more taxpayers benefit from lower tax rates on ordinary, capital gains and dividend income than would benefit from short-term AMT relief. Accordingly, AMT relief should not be paid for by increasing taxes elsewhere. In just a few short years, America's families and small businesses will experience a significant tax increase when the current tax rates on ordinary, capital gains and dividend income expire. Given that AMT relief will, in the short term, predominately benefit relatively fewer taxpayers in high-income, high-tax states, Congress should couple AMT relief with an extension of the current tax rates on ordinary, capital gains and dividend income.