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The 15 Percent Rate on Capital Gains: A Casualty of the Alternative Minimum Tax

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Tax rate reductions on long-term capital gains and qualifying dividends were a key, and highly touted, component of the tax cuts passed in the Jobs and Growth Tax Relief Reconciliation Act of 2003 (JGTRRA). However, like the 2001–2006 tax cuts more broadly, taxpayers affected by the individual alternative minimum tax (AMT) may not pay the advertised lower rates. Even when the AMT is patched so as to prevent it from affecting middle-income taxpayers, as it was in 2006, it can substantially increase the marginal tax rate affecting capital gains and dividends.

The essential interaction creating this rate increase arises because capital gains are included in alternative minimum taxable income (AMTI), and can therefore reduce the taxpayer's AMT exemption, even though the gains are not taxed at AMT rates. When calculating the additional tax owed on the next dollar of capital gains, AMT taxpayers first pay the statutory 15 percent rate on the gain directly. Then, since the increase in AMTI will decrease the value of their AMT exemption, they pay additional tax on the portion of their other income that is no longer sheltered by the AMT exemption. As a result, the actual tax burden on additional realizations is the 15 percent rate on gains plus the applicable AMT rate (26 or 28 percent) multiplied by the exemption phase-out rate (25 percent). Depending on what AMT bracket the taxpayer is in, this interaction increases the effective marginal rate on long-term capital gains and dividends from 15 percent to either 21.5 or 22 percent.

The attached tables illustrate this interaction for two families, one affected by the 26 percent AMT rate and the other by the 28 percent rate. A married couple filing jointly with two children earning \$200,000 in wages and having \$10,000 in long-term capital gains in 2006 would have regular tax liability of \$32,341 (table 1). However, the family is subject to the AMT and so must pay an additional \$2,296 in tax. If the family realized an additional \$1,000 in long-term capital gains, their alternative minimum taxable income would rise by \$1,000, resulting in a \$250 drop in their AMT exemption (from \$52,550 to \$52,300). As a result, the family pays 15 percent on the \$1,000 gain and an additional 26 percent on the \$250 no longer sheltered by the exemption. The family's total income tax payment increases by \$215, corresponding to a marginal tax rate of 21.5 percent on the additional \$1,000 capital gain.

Table 2 shows a similar family with \$300,000 of wages and correspondingly larger deductions for mortgage interest, state and local taxes, and charitable contributions. This family will see their taxes rise by 22 percent as the \$250 reduction in the AMT exemption is taxed at the second AMT rate. An additional \$1,000 in capital gains for this family results in an additional \$220 in taxes.

Leiserson is a research assistant at the Urban Institute and the Tax Policy Center. Views expressed are those of the author alone and do not necessarily reflect the views of the Urban Institute, its board, or its funders. The author thanks Len Burman, Renee Hendley, and Jeff Rohaly for helpful comments and suggestions.

Table 1
AMT Example Calculation (26% AMT Bracket)
Married couple filing jointly with two children, 2006

Actual Income				Income Plus \$1,000 Additional Capital Gain			
Calculate Regular Tax		Calculate Tax with AMT		Calculate Regular Tax		Calculate Tax with AMT	
Wages	\$200,000	Taxable income	\$157,990	Wages	\$200,000	Taxable income	\$159,010
Capital gains	\$10,000			Capital gains	\$11,000		
Total income	\$210,000	<i>Add preference items</i>		Total income	\$211,000	<i>Add preference items</i>	
		Personal exemptions	\$13,200			Personal exemptions	\$13,200
<i>Subtract deductions after limitation</i>		State and local taxes	\$20,000	<i>Subtract deductions after limitation</i>		State and local taxes	\$20,000
Itemized deductions		Limitation of deductions	(\$1,190)	Itemized deductions		Limitation of deductions	(\$1,210)
Home mortgage interest	\$10,000	Alt. minimum taxable income	\$190,000	Home mortgage interest	\$10,000	Alt. minimum taxable income	\$191,000
State and local taxes	\$20,000			State and local taxes	\$20,000		
Charitable contributions	\$10,000	<i>Subtract exemption after phase-out</i>		Charitable contributions	\$10,000	<i>Subtract exemption after phase-out</i>	
Less limitation of deductions	\$1,190	AMT exemption	\$62,550	Less limitation of deductions	\$1,210	AMT exemption	\$62,550
Deductions after limitation	\$38,810	Less phase-out	\$10,000	Deductions after limitation	\$38,790	Less phase-out	\$10,250
Income less deductions	\$171,190	Exemption after phase-out	\$52,550	Income less deductions	\$172,210	Exemption after phase-out	\$52,300
		Income taxable under AMT	\$137,450			Income taxable under AMT	\$138,700
<i>Subtract exemptions after phase-out</i>				<i>Subtract exemptions after phase-out</i>			
Personal exemptions	\$13,200	<i>Calculate tentative AMT</i>		Personal exemptions	\$13,200	<i>Calculate tentative AMT</i>	
Less phase-out	\$0	Tax on wages (\$127,450)	\$33,137	Less phase-out	\$0	Tax on wages (\$127,700)	\$33,202
Exemptions after phase-out	\$13,200	Tax on capital gains (\$10,000)	\$1,500	Exemptions after phase-out	\$13,200	Tax on capital gains (\$11,000)	\$1,650
Taxable income	\$157,990	Tax (tentative AMT)	\$34,637	Taxable income	\$159,010	Tax (tentative AMT)	\$34,852
<i>Calculate regular income tax</i>		Regular income tax	\$32,341	<i>Calculate regular income tax</i>		Regular income tax	\$32,497
Tax on wages (\$147,990)	\$30,841	AMT*	\$2,296	Tax on wages (\$148,010)	\$30,847	AMT*	\$2,355
Tax on capital gains (\$10,000)	\$1,500			Tax on capital gains (\$11,000)	\$1,650		
Tax before credits	\$32,341			Tax before credits	\$32,497		
Regular tax liability	\$32,341	Tax liability w/ AMT**	\$34,637	Regular tax liability	\$32,497	Tax liability w/ AMT**	\$34,852

Marginal Rate on Capital Gains = (New Tax - Old Tax)/(Additional Gain)
Marginal Rate on Capital Gains = (34,852 - 34,637)/1000 = 21.5%

Source: Urban-Brookings Tax Policy Center.

* Tentative AMT less regular income tax before credits.

** Sum of regular income tax and direct AMT liability.

Table 2
AMT Example Calculation (28% AMT Bracket)
Married couple filing jointly with two children, 2006

Actual Income				Income Plus \$1,000 Additional Capital Gain	
Calculate Regular Tax		Calculate Tax with AMT		Calculate Regular Tax	
Wages	\$300,000	Taxable income	\$245,974	Wages	\$300,000
Capital gains	\$10,000			Capital gains	\$11,000
Total income	\$310,000	<i>Add preference items</i>		Total income	\$311,000
		Personal exemptions	\$7,216		
<i>Subtract deductions after limitation</i>		State and local taxes	\$30,000	<i>Subtract deductions after limitation</i>	
Itemized deductions		Limitation of deductions	(\$3,190)	Itemized deductions	
Home mortgage interest	\$15,000	Alt. minimum taxable income	\$280,000	Home mortgage interest	\$15,000
State and local taxes	\$30,000			State and local taxes	\$30,000
Charitable contributions	\$15,000	<i>Subtract exemption after phase-out</i>		Charitable contributions	\$15,000
Less limitation of deductions	\$3,190	AMT exemption	\$62,550	Less limitation of deductions	\$3,210
Deductions after limitation	\$56,810	Less phase-out	\$32,500	Deductions after limitation	\$56,790
Income less deductions	\$253,190	Exemption after phase-out	\$30,050	Income less deductions	\$254,210
		Income taxable under AMT	\$249,950		
<i>Subtract exemptions after phase-out</i>				<i>Subtract exemptions after phase-out</i>	
Personal exemptions	\$13,200	<i>Calculate tentative AMT</i>		Personal exemptions	\$13,200
Less phase-out	\$5,984	Tax on wages (\$239,950)	\$63,686	Less phase-out	\$6,160
Exemptions after phase-out	\$7,216	Tax on capital gains (\$10,000)	\$1,500	Exemptions after phase-out	\$7,040
Taxable income	\$245,974	Tax (tentative AMT)	\$65,186	Taxable income	\$247,170
<i>Calculate regular income tax</i>		Regular income tax	\$59,353	<i>Calculate regular income tax</i>	
Tax on wages (\$235,974)	\$57,853	AMT*	\$5,833	Tax on wages (\$237,170)	\$57,918
Tax on capital gains (\$10,000)	\$1,500			Tax on capital gains (\$11,000)	\$1,650
Tax before credits	\$59,353			Tax before credits	\$59,568
Regular tax liability	\$59,353	Tax liability w/ AMT**	\$65,186	Regular tax liability	\$59,568
				Tax liability w/ AMT**	\$65,406

Marginal Rate on Capital Gains = (New Tax - Old Tax)/(Additional Gain)
Marginal Rate on Capital Gains = (65,406 - 65,186)/1000 = 22%

Source: Urban-Brookings Tax Policy Center.

* Tentative AMT less regular income tax before credits.

** Sum of regular income tax and direct AMT liability.