

A Simple, Progressive Replacement for the AMT
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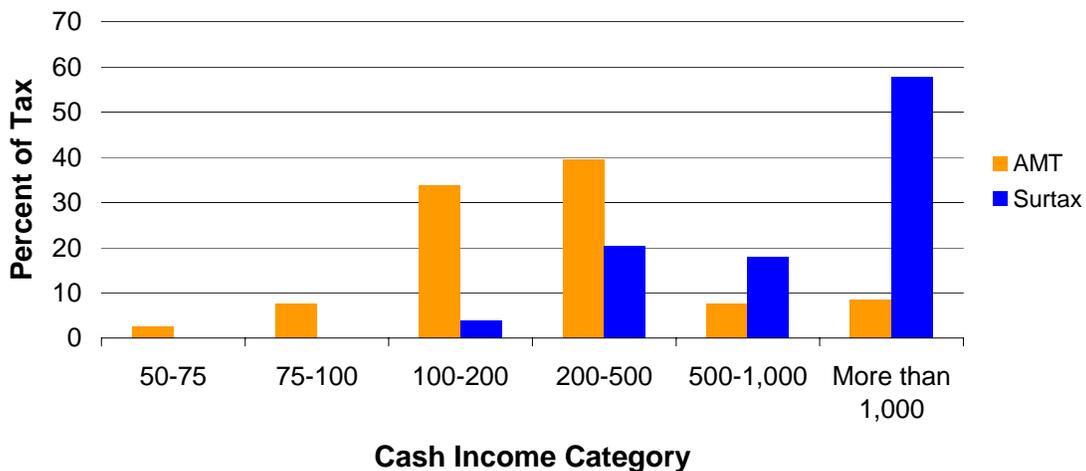
The individual alternative minimum tax (AMT) was originally an add-on tax intended to assure that high income people paid at least some tax. It has morphed and mutated over time, and now is on track to hit 23 million households in 2007, many of them middle- and upper-middle class families with children. This note describes an option that would return the AMT to its original purpose.

In short, the option would repeal the AMT and replace it with an add-on tax of four percent of adjusted gross income (AGI) above \$100,000 for singles and \$200,000 for couples. The thresholds would be indexed for inflation after 2007. The option restores the AMT to its original purpose: an additional tax for very high-income taxpayers to make sure that most pay at least a minimal amount of tax. (The minimum tax was first created by the Revenue Act of 1978 and the add-on tax was merged into it by the Tax Equity and Fiscal Responsibility Act of 1982.) The proposed add-on tax would be extremely simple: subtract the threshold (\$100,000 or \$200,000) from AGI and multiply the difference (if any) by 4 percent. Add that to income tax.

The option is approximately revenue neutral over the ten-year budget window. It would reduce revenues by about \$92 billion between FY07 and FY11, but would gain roughly the same amount from 2012 through 2017. (Table [T07-0140](#))

This option is highly progressive. Most taxpayers with incomes under \$500,000 affected by the proposal would pay lower taxes through 2010. (Table [T07-0134](#) and [T07-0141](#)) Most taxpayers with higher incomes would pay more. After 2010, when the Bush tax cuts expire and AMT liabilities decline under current law, the break-even point shifts down somewhat, but by 2017, the distribution is very similar to that in 2007. (Table [T07-0143](#))

Distribution of AMT and Surtax, 2010



The option would replace a tax that is increasingly encroaching on the middle class with one that would be targeted at those most able to pay. Under current law, more than 40 percent of the AMT would be paid by households with incomes under \$200,000 in 2010. (See figure and [Table T07-0148](#).) Taxpayers with similar incomes would bear less than 4 percent of the AGI surtax, in contrast. Almost 58 percent of the surtax would be borne by taxpayers with incomes over \$1 million. That group would pay only about 8 percent of the AMT in 2010.

It should be noted that the proposal would not negate all of the benefits of the Bush tax cuts through 2010. Almost nobody (0.2 percent of taxpayers) would owe higher taxes in 2010 under the proposal than they would under pre-2001 law—the same share that would owe higher taxes without the AMT reform. (Tables [T06-0277](#) and [T07-0145](#)) Even those with incomes over \$1 million would receive a net tax cut equal to more than 4 percent of income, or almost \$86,000 in 2010. This is substantially smaller than the tax cut originally conferred by the tax cuts, but still larger than most middle-class taxpayers' tax cuts. Moreover, by repealing the AMT, middle-income taxpayers would receive the full benefit of the Bush tax cuts. In [previous analysis](#), we have shown that the AMT takes back almost 30 percent of the tax cuts in 2010. (Table [T06-0272](#))

Taxpayers with incomes below \$500,000 would, on average, receive a tax cut from the proposal, averaging 1/2 percent of income in 2007 for those with income between \$75,000 and \$100,000 and more than 1 percent for those with incomes between \$100,000 and \$500,000. Higher income people would pay more tax, on average, especially those with incomes above \$1 million, who are relatively unlikely to be subject to AMT under current law.

Among taxpayers affected by the proposal, most would face lower *effective* tax rates on ordinary income than under current law, and many would also face lower effective rates on capital gains. (Table [T07-0136](#)) The marginal effective tax rate is the additional tax paid on an additional dollar of income. It is a measure of how the tax system affects incentives to work, save, and engage in tax sheltering. It can differ from statutory tax rates because of income phase-ins and phase-outs. The AMT creates an implicit income tax surcharge because the exemption phases out over a range of income at a 25 percent rate. The surtax is thus equivalent to 25 percent of the AMT rate—either 6.5 percent (25 percent of 26 percent) or 7 percent (25 percent of 28 percent)—for AMT taxpayers in the phase-out range. This surtax applies to both ordinary income and capital gains. Thus, the effective capital gains rate under the AMT can be as high as 22 percent (the 15 percent statutory rate plus the 7 percent AMT surtax). (See [Leiserson, “The 15-Percent Rate on Capital Gains”](#)) Repealing the AMT reduces rates by more than the 4 percent of AGI surtax for many taxpayers, and many others are removed from the AMT rolls and are not affected by the new add-on tax. Most very high income taxpayers would pay higher rates, though.

After 2010, the sum of the top statutory rates in the regular income tax and the add-on tax rate would be higher than the top statutory rates under pre-2001 law—43.6 percent on ordinary income and 24 percent on capital gains. However, the tax system would be much simpler and more transparent, and the vast majority of AMT taxpayers would pay lower taxes.

A tax based on AGI may seem like a new departure for the tax system, but it is not. There are countless implicit taxes on AGI. For example, the child tax credit phases out at a 5-percent rate

on AGI over \$110,000 for couples, creating a 5-percent AGI surtax over a range of income. Itemized deductions and personal exemptions similarly phase out with AGI (although the 2001 tax cuts have partially repealed those provisions in 2007 and will fully repeal them by 2010). A more sweeping reform might subsume all or almost all of the AGI phase-outs into the new AGI surtax, although that would require a higher rate or a lower threshold to be revenue neutral.

Further Reading:

For other options to repeal or reform the AMT, see [Options to Fix the AMT](#).

The full set of estimates related to this option is [available](#).

The Tax Policy Center's [AMT page](#) contains a variety of resources related to the AMT.