

## The Individual AMT: More Than a Small Fix Is Needed

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The typical taxpayer thinks that the individual alternative minimum tax will never apply to him. A small fix in 1998—which essentially prevented some individuals from paying the AMT because they claimed the child and other personal credits—may even have reinforced that impression. The purpose of the AMT, after all, is to collect tax from those who invested in tax shelters and had extraordinary levels of questionable deductions, wasn't it?

Well, perhaps that was the original purpose, but that's not the law. Under current law, all of the following are true. First, because many dollar amounts in the AMT are not indexed for inflation, more taxpayers become subject to it every year. Within a decade, many typical middle-income households with no involvement whatsoever in tax shelters will owe AMT. Second, typical and normal deductions and credits, many of which are not considered in any way abusive, are actually treated as "preference" items subject to the AMT. Every taxpayer, in fact, has one or more of these preferences because they extend even to the personal and dependency exemptions allowed for all persons in the taxpayer's family. Third, many more individuals owe AMT than probably pay it or even know they should pay it. That creates considerable problems of complexity and enforcement for the IRS.

How could these developments have occurred? Wasn't the goal of tax reform to achieve some simplification, at least for taxpayers not engaged in shelters or complex transactions? Well, in the beginning, that was true. But the process of tax reform was one where the continual set of compromises made along the way led to a backing away from broader reforms and then to backdoor approaches to recoup the lost revenues and still keep statutory rates low. More and more revenue raisers were added through devices such as expanding the AMT. Congress also knew that by failing to index the AMT it was booking long-term revenues that would be hard to maintain.

Many efforts at reforming the AMT deal only with the failure to index. Under current law, for instance, many married couples with two children, average income, and no more deductions than their state and local taxes are scheduled to pay AMT in the future. As their income and state and local taxes—which are counted as preference items—grow with normal inflation and economy-wide growth, these taxpayers are less likely to be excluded from the AMT. But while a reform that indexes the AMT is worthwhile, it still ignores whether or not the tax makes sense, whether its base includes items that should not be subject to taxation, and whether the administrative hassle and complexity are worth the trouble in the first place.

A few of the preference items in the AMT have attributes associated with preferential treatment, such as generous depletion allowances or the tax exemption for interest received on private activity bonds. In those cases the taxpayer may be excluding from taxable income a significant portion of real income received. But most of these items are not large in terms of alternative minimum tax collections. Other items included at different times, such as an alternative depreciation schedule, are more debatable since they seem to deny to some taxpayers even those deductions that would be allowed if economic income were calculated accurately. Some of these provisions are enormously complex, as well, for they require the taxpayer to keep multiple records for years under alternative methods of calculation.

There is little excuse for inclusion of items that are legitimate deductions reflecting a lower ability to pay tax. The standard deduction allowed to nonitemizers is treated as a preference item under the AMT. So also are extraordinary and legitimate work expenses when deducted as miscellaneous itemized deductions. The inclusion of personal exemptions as a preference item implies Congress believes that a dependency exemption is not an appropriate adjustment to ability to pay tax, but instead accords the taxpayer special treatment. In effect, for AMT purposes, the law implies that a family of four has the same ability to pay tax as a family of two with equal income.

Finally, there are those items that under some theories might not be deductions under an income tax, but under other theories are quite reasonable. It is inconsistent and arbitrary to try to tax them through an AMT. These include state and local tax deductions and those few medical deductions allowed for regular tax, but not minimum tax, purposes. If there is a rationale for further limiting these deductions, it should be applied directly in the normal income tax, not through the more complex AMT.

The AMT is a classic case in which Congress and the executive branch believe that the law doesn't make much sense, but they have been unable to act because of multiple constraints. Because the AMT applies to those with higher-than-average incomes, elected officials are reluctant simply to reduce it without doing something for other income groups. A cut in AMT taxes thus is less popular than a general tax cut because the former benefits so many fewer taxpayers. Next, there are some still wedged to this tax in hopes that it can serve as a wedge for further reform of the tax system. Finally, any change must wind its way through a budget process that generally has required tax cuts be paid for by someone else.

The number of taxpayers who are liable for the AMT, but do not pay it immediately, is probably considerable. Lack of knowledge on the taxpayer's part is one reason. According to projections of the Joint Committee on Taxation, the hundreds of thousands of taxpayers now owing AMT will soon grow to millions. This could represent a serious area of administrative and complexity for the new IRS. In summary, the individual AMT is in need of a good fix or outright elimination. Simply indexing it is not enough. Everyone has known these facts for over a decade, but the increasing number of filers under an unindexed AMT will force action in the very near future—action that goes far beyond the simple, necessary, but modest fix for personal credits that was included in tax legislation in 1998.

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