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Tax Rates on Capital Gains and Dividends Under the AMT

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Recent tax acts sharply lowered tax rates on long-term capital gains and dividend income. For millions of taxpayers, however, the alternative minimum tax limits the benefits from these cuts by increasing the effective marginal tax rates on capital gains and dividend income. The culprit is the phaseout of the AMT exemption.

Just like the regular income tax, the AMT taxes capital gains and dividend income at a maximum rate of 15 percent. The mere presence of that income, however, increases the effective tax rate for affected taxpayers by reducing the amount of income they can exclude from the AMT.

The AMT exemption — $44,350 for single filers and $66,250 for couples filing jointly in 2007 — phases out for high-income taxpayers. For taxpayers with alternative minimum taxable income above a certain threshold, the AMT exemption decreases at a rate of 25 cents for each additional dollar of AMTI. The 2007 AMT exemption for single taxpayers, for example, phases out over the AMTI range from $112,500 to $289,500. (For joint filers, the range is $150,000 to $415,000.) Within that range, the effective marginal tax rate on capital income equals the statutory rate of 15 percent plus the increase in alternative tax attributable to the reduced exemption amount.

The AMT applies two statutory rates to all AMTI above the exemption amount: 26 percent on the first $175,000 and 28 percent on any excess. A taxpayer with AMTI above the start of the AMT exemption phaseout, but within the 26 percent bracket, faces a 21.5 percent effective tax rate on gains and dividends — the 15 percent statutory rate plus an additional 6.5 percent effective tax rate due to the exemption phaseout (the 26 percent AMT rate multiplied by the 25 percent phaseout rate). Similarly, a single taxpayer with AMTI in the 28 percent bracket, but within the phaseout range, faces an effective rate equal to 22 percent (15 percent statutory rate plus 7 percent, one-fourth of the 28 percent AMT rate).

The phaseout of the AMT exemption causes the effective tax rate on capital gains under the AMT to climb as income increases. The rate starts at 15 percent for those with AMTI below the phaseout threshold, jumps to 21.5 percent and then 22 percent in the phaseout range, and then reverts back to 15 percent once the AMT exemption is fully phased out.

Because of the exemption phaseout, nearly half of all AMT taxpayers — 46.5 percent — face 2007 marginal rates of 21.5 or 22 percent on capital gains and dividend income (see chart). Married taxpayers filing jointly are more likely to face higher effective rates on gains and dividends than single taxpayers and married taxpayers filing separately — about half of joint filers have effective marginal tax rates of 21.5 or 22 percent on capital gains, compared to about 37 percent of other taxpayers.

Percent of AMT Taxpayers Subject to 15, 21.5, or 22 Percent Effective Marginal Tax Rate on Capital Income (2007), by Filing Status