

**STATEMENT OF NINA E. OLSON
NATIONAL TAXPAYER ADVOCATE**

BEFORE THE

**SUBCOMMITTEE ON TAXATION AND IRS OVERSIGHT
COMMITTEE ON FINANCE
UNITED STATES SENATE**

MAY 23, 2005

Mr. Chairman and distinguished Members of the Subcommittee:

Thank you for inviting me to testify today at this hearing, which is intriguingly titled, “Blowing the Cover on the Stealth Tax: Exposing the Individual AMT.” I have tried to further this mission by repeatedly calling attention to the deficiencies in the individual alternative minimum tax (AMT).¹ Indeed, if I were given the opportunity to make just one change to the Internal Revenue Code, I would use it to eliminate the individual AMT.²

Overview

The AMT was originally designed to prevent wealthy taxpayers from using tax shelters to avoid paying their fair share of taxes. However, Congress has changed the tax laws many times since the inception of the AMT and shut down many of the tax-avoidance opportunities that existed in the 1960s and 1970s. Today, the AMT affects millions of taxpayers with no tax-avoidance motives at all – unless one considers choosing to live in a high-tax state or choosing to have children to be a tax-avoidance motive. For 2002, the Treasury Department found that fully 51 percent of aggregate AMT tax preference dollars are attributable to the disallowance of the state and local tax deduction under the AMT, and 22 percent of aggregate AMT tax preference dollars are attributable to the

¹ In my 2001 Annual Report to Congress, I recommended that the AMT be repealed or, at a minimum, substantially revamped to accomplish its original objective of preventing high-income taxpayers from escaping taxation through the use of tax-avoidance techniques. National Taxpayer Advocate 2001 Annual Report to Congress 166-177. In my 2003 Annual Report to Congress, I designated the AMT as the most serious problem facing taxpayers. National Taxpayer Advocate 2003 Annual Report to Congress 5-19. This report was recently cited by the American Bar Association in presenting its recommendation that Congress repeal the individual AMT. Report of the American Bar Association Section of Taxation to the American Bar Association House of Delegates (Aug. 2004) (transmitted with Letter from Kenneth W. Gideon, Chair, American Bar Association Section of Taxation, to Senators Grassley and Baucus and Congressmen Thomas and Rangel (Nov. 29, 2004)). In my 2004 Annual Report to Congress, I reiterated my recommendation that the AMT be repealed. National Taxpayer Advocate 2004 Annual Report to Congress 383-385.

² As a matter of fairness, the repeal of the AMT would require that Congress address the treatment of unused prior-year minimum tax credits, perhaps simply by retaining section 53 of the Code.

disallowance of personal exemptions.³ Thus, nearly three-quarters of the increase in income subject to taxation under the AMT results simply because of taxpayers' place of residence or family composition.

Moreover, the AMT is now affecting increasing numbers of middle-income taxpayers, because the amount of income exempt from the AMT (the AMT "exemption amount") is not indexed for inflation. When Congress first enacted a minimum tax in 1969, the exemption amount was \$30,000 for all taxpayers. If Congress had indexed that amount, it would be equal to about \$157,400 today.⁴ Instead, the exemption amount, after a temporary increase that will expire after 2005, is \$45,000 for married taxpayers and \$33,750 for most other taxpayers.⁵ As a result, it is now projected that in 2010, 34.8 million individual taxpayers – or 34 percent of individual filers who pay income tax – will be subject to the AMT.⁶ Among the categories of taxpayers hardest hit, 94 percent of married couples with adjusted gross income (AGI) between \$75,000 and \$100,000 and two or more children will owe AMT.⁷

The burden that the AMT imposes is substantial. In dollar terms, it is estimated that the average AMT taxpayer owed an *additional* \$6,000 in tax in 2004.⁸ In terms of complexity and time, taxpayers often must complete a 12-line worksheet,⁹ read eight pages of instructions,¹⁰ and complete a 55-line form¹¹ simply to determine whether they

³ Department of the Treasury, Office of Tax Analysis (unpublished tabulation) *cited in* Leonard E. Burman & David Weiner, *Suppose they took the AM out of the AMT?* (Nov. 13, 2004) (available at www.taxpolicycenter.org).

⁴ Department of Labor, Bureau of Labor Statistics, *Consumer Price Index – All Urban Consumers (CPI-U)* (April 30, 2005). Congress acted after hearing testimony that 155 taxpayers with adjusted gross incomes above \$200,000 had paid no federal income tax for the 1966 tax year. See The 1969 Economic Report of the President: Hearings before the Joint Economic Comm., 91st Cong., pt. 1, p. 46 (1969) (statement of Joseph W. Barr, Secretary of the Treasury). The consumer price index has more than quintupled since 1966, so the kinds of taxpayers who caught Congress' attention back then would be making over \$1.19 million today. See Department of Labor, Bureau of Labor Statistics, *Consumer Price Index – All Urban Consumers (CPI-U)* (April 30, 2005). Yet the AMT today is not primarily affecting taxpayers with incomes over \$1.19 million. By 2010, it has been estimated that 83 percent of all taxpayers affected by the AMT will have incomes under \$200,000 – and 37 percent will have incomes under \$100,000. See Leonard E. Burman et al., *The Individual Alternative Minimum Tax: A Data Update*, table 4 (Aug. 30, 2004) (available at www.taxpolicycenter.org and at 2004 TNT 175-15).

⁵ IRC § 55(d).

⁶ Department of the Treasury, Office of Tax Analysis (unpublished data furnished on Dec. 3, 2004).

⁷ Leonard E. Burman et al., *The Individual Alternative Minimum Tax: A Data Update*, table 2 (Aug. 30, 2004) (available at www.taxpolicycenter.org and at 2004 TNT 175-15).

⁸ Leonard E. Burman et al., *The Individual Alternative Minimum Tax: A Data Update*, table 3 (Aug. 30, 2004) (available at www.taxpolicycenter.org and at 2004 TNT 175-15). Final IRS data for 2004 is not yet available.

⁹ 2004 Form 1040 Instructions, at 35.

¹⁰ 2004 Instructions for Form 6251.

¹¹ 2004 Form 6251, *Alternative Minimum Tax – Individuals*.

are subject to the AMT. Thus, it is hardly surprising that 75 percent of AMT taxpayers hire practitioners to prepare their returns.¹²

Perhaps most disturbingly, it is often very difficult for taxpayers to determine in advance whether they will be hit by the AMT. As a result, many taxpayers are unaware that the AMT applies to them until they receive a notice from the IRS, and some discover they have AMT liabilities that they did not anticipate and cannot pay. To make matters worse, the difficulty of projecting AMT tax liability in advance makes it challenging for taxpayers to compute and make required estimated tax payments, which often results in these taxpayers being subject to penalties.

At some point in the next few years, we will reach a point where it will cost more for Congress to repeal the AMT than to repeal the regular tax and leave the AMT intact.¹³ In a very real sense, then, the AMT is ceasing to fulfill its intended mission to prevent tax avoidance by the wealthy and is instead becoming the *de facto* tax system for millions of Americans. The obvious challenge in repealing the AMT is that its increasing revenue stream has been built into revenue estimates, so if it is repealed, either Congress will have to raise tax receipts in other ways or budget deficits will balloon. These alternatives admittedly are not appealing, but I have no doubt there are solutions that are far preferable to the status quo. Significantly, the longer Congress waits to act, the more dependent the government will become on AMT revenue and the harder it therefore will become to repeal it.

While the concept of a minimum tax is not unreasonable, the AMT as currently structured has morphed into something that was never intended: It is penalizing taxpayers for such nontax-driven behavior as having children or selecting a state of residence; it is hitting taxpayers it was never intended to hit because its exemption amount has not been indexed for inflation; it is taking large numbers of taxpayers by surprise – and subjecting them to penalties to boot; it is imposing onerous compliance burdens; it is altering the distribution of the tax burden that exists under the regular tax system; it is changing the tax incentives built into the regular tax system; and it is neutralizing the effects of changes to tax rates imposed under the regular tax system.

Background of the AMT

The concept of a minimum tax was initially developed in response to reports that a small, wealthy group of taxpayers was avoiding taxes altogether through the use of tax avoidance techniques.¹⁴ In 1969, the House of Representatives adopted

¹² Tax Year 2002, IRS Compliance Data Warehouse, Individual Returns Transaction File (IRTF).

¹³ While estimates of when this crossover point will occur vary slightly, the most recent modeling by the Tax Policy Center, a joint venture of the Urban Institute and Brookings Institution, projects it will occur by 2008. See Leonard E. Burman, *The Individual Alternative Minimum Tax: A Presentation to the President's Advisory Panel on Federal Tax Reform* (March 3, 2005) (available at www.taxpolicycenter.org).

¹⁴ *The 1969 Economic Report of the President: Hearings before the Joint Economic Comm.*, 91st Cong., pt. 1, p. 46 (1969) (statement of Joseph W. Barr, Secretary of the Treasury); Committee on Ways and

recommendations of the Treasury Department and passed a bill to impose a minimum tax by limiting certain tax preference items, in the aggregate, to 50 percent of gross income.¹⁵ This approach required the use of a complex formula designed to allocate itemized deductions between taxable income and non-taxable income and to disallow those deductions allocated to non-taxable income.¹⁶

The Senate changed the bill, adopting instead a tax on specified preference items in excess of a \$30,000 exemption amount.¹⁷ The final bill followed the Senate's approach and imposed an add-on tax of 10 percent on nine specific tax preference items when the sum of the preference items exceeded \$30,000.¹⁸

The Tax Reform Act of 1976 and the Revenue Act of 1978 both made modifications to the add-on tax. The 1976 Act, among other things, increased the add-on tax rate to 15 percent and lowered the exemption amount from \$30,000 to \$10,000.¹⁹ The 1978 Act went a step further, restructuring the tax into two components. The add-on tax was retained for all tax preferences except the capital gains deduction and excess itemized deductions, and a new alternative minimum tax was established to adjust the taxpayer's income for these two items of tax preference. This new alternative minimum tax (AMT) imposed a progressive three-tiered rate structure on AMT: 10 percent on AMT income between \$20,001 and \$60,000; 20 percent on AMT income between \$60,001 and \$100,000; and 25 percent on AMT income over \$100,000.²⁰

In 1982, Congress repealed the add-on tax and replaced it with the alternative minimum tax (AMT).²¹ Although Congress has enacted many technical changes over the past two decades, the basic structure of the AMT rules has remained intact.

How the AMT Is Computed

The AMT's method of calculation vividly demonstrates its complexity. The AMT requires a separate set of computations from the regular income tax, with unique rules governing the recognition of income and the timing of deductions and credits.

Means of the U.S. House of Representatives and Committee on Finance of the U.S. Senate, 91st Cong., *Tax Reform Studies and Proposals*, U.S. Treasury Department, pt. 1, p. 132 (Comm. Print 1969).

¹⁵ H.R. 13270, § 301(a) (version passed by the House of Representatives on Aug. 8, 1969).

¹⁶ See H.R. Conf. Rep. No. 91-782, p. 301 (1969).

¹⁷ H.R. 13270 (substituted version passed by the Senate on Dec. 11, 1969).

¹⁸ Tax Reform Act, Pub. L. No. 91-172, § 301 (1969). The nine specified tax preference items were (1) excess investment interest income, (2) accelerated depreciation on personal property, (3) accelerated depreciation on real property, (4) amortization of certified pollution control facilities, (5) amortization of railroad rolling stock, (6) tax benefits from stock options, (7) bad debt deductions of financial institutions, (8) depletion, and (9) the deduction for capital gains.

¹⁹ Tax Reform Act, Pub. L. No. 94-455, § 301 (1976).

²⁰ Revenue Act, Pub. L. No. 95-600, § 421 (1978).

²¹ Tax Equity and Fiscal Responsibility Act, Pub. L. No. 97-248, § 402(a) (1982).

Taxpayers are often required to maintain two sets of records – one for regular income tax purposes and one for AMT purposes.

The determination of AMT liability, if any, involves an eight-step process:

1. The taxpayer must calculate his regular tax liability. The regular income tax rules provide preferred treatment for certain types of income and allow taxpayers to claim certain exemptions, deductions, exclusions and credits.
2. The taxpayer must determine whether he is subject to additional tax under the AMT regime. The IRS provides a 12-line worksheet (Worksheet To See if You Should Fill in Form 6251)²² to help taxpayers determine whether they may be subject to the AMT. If the worksheet indicates that a taxpayer is *potentially* subject to the AMT, the taxpayer must complete Form 6251 (Alternative Minimum Tax – Individuals), which contains 55 lines. Many taxpayers are required to complete Form 6251 – only to find that they do not have an AMT liability.
3. The taxpayer must compute his alternative minimum taxable income (AMTI) on Form 6251. This computation generally requires taxpayers to give up the benefit of tax preference items to which they are entitled under the regular tax system (e.g., dependency exemptions, a standard deduction, and itemized deductions for state and local taxes, employee business expenses and legal fees).²³
4. The taxpayer must determine an “exemption amount” to which he is entitled based on filing status. The AMT exemption amounts are temporarily boosted to \$58,000 for married taxpayers²⁴ and \$40,250 for most other taxpayers.²⁵ After 2005, however, the exemption amounts are scheduled to drop back to \$45,000 for married taxpayers and \$33,750 for most other taxpayers.²⁶ The exemption amount is phased out for married taxpayers with AMTI exceeding \$150,000 and non-married taxpayers with AMTI exceeding \$112,500.²⁷

²² 2004 Form 1040 Instructions, p. 35.

²³ Required adjustments listed on Form 6251 include adjustments for medical and dental expenses, state and local taxes, certain non-allowable home mortgage interest, miscellaneous itemized deductions, tax refunds, investment interest, depletion, certain net operating losses, interest from specified private activity bonds, qualified small business stock, the exercise of incentive stock options, estates and trusts, electing large partnerships, property dispositions, depreciation on certain assets, passive activities, loss limitations, circulation costs, long-term contracts, mining costs, research and experimental costs, income from pre-1987 installment sales, intangible drilling costs, certain other adjustments and alternative tax net operating loss deductions. See IRC §§ 56 and 57; IRS Form 6251 (Alternative Minimum Tax – Individuals), Part I.

²⁴ In cases where married persons file separate returns, each taxpayer is entitled to 50 percent of the exemption amount allowable to married taxpayers who file joint returns.

²⁵ Working Families Tax Relief Act, Pub. L. No. 108-311, § 103 (2004).

²⁶ IRC § 55(d).

²⁷ IRC § 55(d)(3).

5. The taxpayer must compute his “taxable excess” by subtracting the exemption amount from his AMTI.
6. A taxpayer with a positive “taxable excess” must compute his “tentative minimum tax.” A “taxable excess” of \$175,000 or less is taxed at a 26 percent rate and any additional “taxable excess” is taxed at a 28 percent rate. The sum of the two amounts is the “tentative minimum tax.”²⁸
7. The taxpayer must compute his “alternative minimum tax” or “AMT.” The AMT is equal to the excess of the taxpayer’s tentative minimum tax, if any, over his regular tax liability (reduced by any tax from Form 4972 (Tax on Lump Sum Distributions) and any foreign tax credit from Form 1040). If the net result is a negative number or zero, the taxpayer does not owe AMT.
8. If the taxpayer owes AMT, he computes his final tax liability by adding his regular tax liability and his AMT liability.²⁹

A taxpayer who is subject to the AMT accrues AMT credits.³⁰ These credits may be used in the future when the taxpayer’s regular tax liability, reduced by other nonrefundable credits, exceeds the taxpayer’s tentative minimum tax for the year. However, these credits may be applied only to “deferral” items -- not to “exclusion” items. Deferral items are those that are accounted for in different tax years in the regular tax and AMT systems. For example, the AMT in some instances requires taxpayers to depreciate property over a longer period of time. Exclusion items are adjustments and tax preference items that result in the permanent disallowance of certain tax benefits such as the standard deduction, personal exemptions and certain itemized deductions. Thus, many individual taxpayers will never be able to use their AMT credits.

Problems with the AMT

At the risk of some redundancy, the following is a concise list of the most significant problems arising from AMT:

- Impact on “Wrong” Taxpayers. The AMT no longer targets just wealthy taxpayers engaged in tax avoidance. As noted above, the number of AMT filers is projected to grow to nearly 35 million by 2010.³¹ Of that total, a staggering

²⁸ IRC § 55(b)(1)(A).

²⁹ In most cases, the taxpayer’s final tax liability is simply the greater of his regular tax liability or his tentative minimum tax liability. But because the Code requires adjustments for tax from Form 4972 (Tax on Lump Sum Distributions) and any foreign tax credit from Form 1040, the Seventh and Eighth steps are required to ensure that taxpayers with these tax items obtain the correct result.

³⁰ IRC § 53.

³¹ Department of the Treasury, Office of Tax Analysis (unpublished data furnished on Dec. 3, 2004).

81 percent of taxpayers with incomes between \$100,000 and \$200,000 will be subject to the AMT.³²

- Lack of AMT Knowledge. As noted above, taxpayers often file their returns not knowing about the AMT or expecting to be subject to it, but then receive bills relating to the AMT that they are not prepared to pay. In fiscal year 2004, the IRS closed nearly 23,000 examinations that were initiated because of suspected AMT liabilities. These examinations resulted in additional tax assessments of over \$39 million – more than \$1,700 per return.³³
- Complexity. The individual AMT computations are completely separate from the regular income tax computations. As described above, taxpayers may need to fill out a 12-line worksheet and then a 55-line form (IRS Form 6251, Alternative Minimum Tax – Individuals) just to determine whether they are subject to AMT. Other complexities of the AMT include the re-computation of the foreign tax credit,³⁴ its effects on incentive stock options³⁵ and capital gains rates,³⁶ and the treatment of income of minor children (the so-called kiddie tax).³⁷
- Failure to Index AMT Exemptions for Inflation. Regular income tax standard deductions, exemptions and filing thresholds are all adjusted for inflation. As discussed above, however, the AMT exemption amounts are not. The absence of an AMT indexing provision is largely responsible for the increasing numbers of middle-class taxpayers who are subject to the AMT regime.³⁸
- Adverse Impact on Families. Married taxpayers will be almost 20 times as likely as single taxpayers to pay AMT in tax year 2010. One study projected that approximately 5.7 million taxpayers will pay AMT in 2010 simply because they lose the benefit of personal exemptions under the AMT.³⁹
- Loss of Itemized Deductions. An individual taxpayer must add back certain itemized deductions when computing AMT.⁴⁰ This adjustment causes particular

³² See Leonard E. Burman, *The Individual Alternative Minimum Tax: A Presentation to the President's Advisory Panel on Federal Tax Reform* (March 3, 2005) (available at www.taxpolicycenter.org).

³³ IRS Wage & Investment Operating Division, Audit Information Management System (FY 2004 data).

³⁴ IRC § 59(a).

³⁵ IRC § 56(b)(3).

³⁶ IRC § 55(b)(3).

³⁷ IRC § 59(j).

³⁸ The effect of the absence of AMT-exemption indexing is compounded by the fact that key tax preference items that are included in AMTI – e.g., the standard deduction and personal exemptions – are indexed annually.

³⁹ Leonard E. Burman, William G. Gale & Jeffery Rohaly, *The AMT: Projections and Problems*, Tax Notes, July 7, 2003, pp. 105-106 (available at www.taxpolicycenter.org).

⁴⁰ IRC § 56(b) & (e). Common itemized deductions that must be added back to income include, but are not limited to, state and local taxes, real estate and personal property taxes, mortgage interest not used

difficulties for taxpayers with large expenditures such as medical bills, legal fees in court settlements, state and local taxes, or employee business expenses.

- Unpredictability of Estimated Tax Payments. Because the law is so complicated, it is difficult, if not impossible, to predict whether an individual will be subject to the AMT. This uncertainty causes problems in paying the correct estimated tax for the year and can result in penalties for underpayment. In tax year 2001, for example, more than 176,000 taxpayers facing AMT were also required to pay nearly \$103 million in estimated tax penalties.⁴¹
- Taxation of Incentive Stock Options. A taxpayer's exercise of incentive stock options creates a paper (phantom) gain in the year the stock is purchased (the option exercise). This gain is not taxed under the regular tax rules but is taxed for AMT purposes. The gain is the difference between the option price and the market value of the stock on the date the option is exercised to purchase the shares.
- Limitation on Availability of General Business Credits. General business tax credits are not denied for purposes of computing AMTI but are limited by the taxpayer's tentative minimum tax.⁴² To illustrate, assume a taxpayer has a regular tax liability of \$10,000 prior to credits, tentative minimum tax of \$9,000, and a \$2,000 credit under IRC § 44 for constructing an access ramp to his business for disabled individuals. Absent the credit, the AMT has no effect on this taxpayer because his regular tax liability exceeds his tentative minimum tax. However, the disabled access credit would reduce the taxpayer's regular tax liability to \$8,000, which is below his tentative minimum tax. Therefore, the taxpayer is only entitled to a credit amount of \$1,000 and must carry back or carry forward the \$1,000 credit balance. Under these circumstances, the taxpayer is required to complete Form 6251 and attach it to his return – even though the taxpayer does not have an AMT liability – to substantiate his entitlement to a portion of the credit. A 2000 Treasury analysis estimated that taxpayers will lose nearly 12 billion dollars in tax credits, mostly business credits, in 2010 because of the AMT.⁴³
- Timing Issues Resulting from AMT Tax Credit Regime. The portion of AMT attributable to timing items reflects the difference between when certain deductions are allowable under the AMT and when the same deductions are

for the purchase or improvement of a personal residence, medical expenses exceeding 7.5 percent but less than 10 percent of adjusted gross income, and certain miscellaneous itemized deductions such as employee business expenses and legal fees.

⁴¹ Tax Year 2001, Compliance Research Information System, Model IFM 2003.

⁴² IRC § 38(c)(1).

⁴³ Department of the Treasury, Office of Tax Analysis, Paper 87, table 1 at p. 19, June 2000; IRC § 55(c)(2).

allowable under the regular income tax. The taxpayer can claim an AMT credit only in subsequent years when the regular tax exceeds the AMT.

- Requirement of Two Sets of Records. Taxpayers often must keep separate records for regular tax and AMT purposes. For example, assume a taxpayer placed an office building into service prior to 1999 and is claiming straight-line depreciation on the building. The taxpayer must depreciate the building over a 39-year period for regular tax purposes,⁴⁴ but for AMT purposes the depreciation period is 40 years.⁴⁵
- Inconsistent Treatment of Carryover Items. When a taxpayer loses a tax benefit because of the AMT, the taxpayer may or may not be entitled to carry the benefit to another tax year, and the carryover periods vary from item to item. For example, an unused credit otherwise allowable for placing a qualified electric vehicle into service may not be carried over.⁴⁶ If the credit cannot be used in the year in which the vehicle is placed into service, it is permanently lost. Unused general business credits, on the other hand, generally may be carried back one year and carried forward 20 years.⁴⁷ Unused foreign tax credits generally may be carried back two years and forward five years.⁴⁸
- Two Computations of Capital Gains Tax. Capital gains are taxed for regular tax purposes at lower rates than the AMT rates. Because Congress wanted to preserve tax-favored capital gains treatment under the AMT regime, a taxpayer with capital gains who owes AMT must complete 20 lines on Form 6251 after having already completed a Schedule D (Capital Gains and Losses) for regular tax purposes.
- Increased Use of Paid Preparers. Approximately 55 percent of taxpayers without AMT liabilities pay to have their returns prepared. Where a taxpayer has an AMT liability, the use of paid preparers jumps to 75 percent.⁴⁹
- High AMT Marginal Tax Rates Due to Phase-out of AMT Exemption. As described above, the AMT rules impose tax at a rate of 26 percent on a “taxable excess” (*i.e.*, AMTI reduced by the applicable AMT exemption amount) up to \$175,000 and 28 percent on higher amounts. However, the AMT exemptions phase out at a 25 percent rate for married taxpayers with AMTI exceeding

⁴⁴ IRC § 168(c).

⁴⁵ IRC § 56(a)(1)(A)(i) (referencing IRC § 168(g)).

⁴⁶ A credit may be carried to another taxable year only if the Code expressly provides for it. In the case of the credit for placing a qualified electric vehicle into service, carryovers are not authorized. See IRC § 30(a).

⁴⁷ IRC § 39(a).

⁴⁸ IRC § 904(c).

⁴⁹ Tax Year 2002, IRS Compliance Data Warehouse, Individual Returns Transaction File (IRTF).

\$150,000 and non-married taxpayers with AMTI exceeding \$112,500.⁵⁰
Therefore, the AMT marginal tax rate can reach 35 percent.

Examples of AMT Impact

The following examples illustrate the impact of the AMT in three situations:⁵¹

AMT Penalty for Having Children: The (modified) Brady Bunch. Mr. and Mrs. Brady live in California in a rented home with their six children ages 5-16. They claim the “married filing jointly” filing status and take the \$9,700 standard deduction in 2004. Mr. Brady, an architect, made \$73,160. Mrs. Brady worked part-time as a teacher and earned \$25,000. The Bradys owe \$3,394 in taxes under the regular tax system, but their tax bill rises to \$4,442 with the AMT because the tax benefits of the personal exemptions for their children are lost under the AMT.

AMT Marriage Penalty. Assume the same facts as in the prior example except that Mr. and Mrs. Brady did not marry. If each used the “Head of Household” filing status and claimed their own three children, the AMT would not apply to either of them and their combined tax bill would be lower. Mrs. Brady would pay no tax and get \$4,125 in refundable credits (a \$1,987 EITC credit and a \$2,138 child tax credit), and Mr. Brady would pay tax of \$6,006. Their combined tax liability would be \$1,881 (*i.e.*, \$6,006 minus \$4,125) – or \$2,561 less than their tax liability if they were married. Part of the difference in tax in these two examples is attributable to the general marriage penalty, but a significant portion is attributable solely to the AMT.

AMT Penalty for High State and Local Taxes. A taxpayer filed a joint return claiming two exemptions for 2003. The taxpayer had an adjusted gross income (AGI) of \$185,000 and paid state income and property taxes totaling \$27,000. The taxpayer had 90 percent of his regular tax liability withheld from his paycheck. When the taxpayer prepared his return, he discovered that he had an additional AMT tax liability of \$3,908 because the tax benefits of the deduction for state and local taxes are lost under the AMT. Because of the additional AMT tax liability, he also owed a penalty for failure to pay estimated tax in the amount of \$101.

AMT Penalty for Combination of Having Children and Requirement to Use “Married Filing Separately” Filing Status. A mother of five earned \$55,000 in 2003. She was separated from her husband during the last five months of the year and thus claimed “married filing separately” filing status. Because of the child tax credit, she had no tax liability under the regular tax rules. She therefore did not have any tax withheld from her paychecks. When she prepared her tax return, however, she discovered that she had a tax liability of \$1,760 due to the AMT. Because of the AMT tax liability, she also owed a penalty for failure to pay estimated tax in the amount of \$45.

⁵⁰ IRC § 55(d)(3).

⁵¹ These examples illustrate common AMT issues we have seen in the Taxpayer Advocate Service, but they do not represent the facts of any particular case.

Conclusion

To be viewed as fair, a tax system must be transparent. Yet the complexity of the AMT is such that many if not most taxpayers who owe the AMT do not realize it until they prepare their returns. It adds insult to injury when many of these taxpayers discover that they also owe a penalty for failure to pay sufficient estimated tax because they did not factor in the AMT when they computed their withholding exemptions or estimated tax payments. Taxpayers subjected to this treatment may wonder whether their government is dealing fairly with them. To say the least, “gotcha” taxation is not good for taxpayers or the tax system.

Clearly, there are many practical, policy, and political challenges to repealing the individual AMT. But these challenges will continue to grow over time as the government, absent congressional action, becomes increasingly dependent on AMT revenue. With all the problems inherent in the AMT, I don’t think taxpayers will stand for it when the AMT begins to hit tens of millions of taxpayers within the next few years. The AMT is a time bomb, and it is set to detonate within the next five years. I strongly urge Congress to act before the AMT explosion.