INDIVIDUAL ALTERNATIVE MINIMUM TAX (AMT)

STATUS

The American Taxpayer Relief Act, Public Law 112-240, has made the temporary increases in the income levels at which the Alternative Minimum Tax (AMT) applies, known as the AMT “patch” permanent.

The levels that apply to 2012 income are $78,750 for married couples filing jointly and $50,600 for individuals. For 2013, the amounts are $80,800 and $51,900 respectively.

For taxable years beginning with 2013, those amounts are indexed for inflation.

BACKGROUND

Forty years ago, the term “AMT” was something rich people had to worry about. However, the AMT now affects tens of millions of Americans, including a substantial amount of middle-class citizens. As a result, Congress is again wrestling with how to mitigate the impact on average taxpayers.

The corporate and individual alternative minimum taxes are "extra" taxes some individuals and corporations pay on top of their "regular" income tax. The original idea behind this tax was to prevent people or businesses with very high incomes from using special tax benefits to pay little or no tax. There are separate AMT requirements for individuals and corporations. The AMT was first enacted in 1969, following the Congressional testimony by the Secretary of Treasury reporting that 155 high-income individuals paid no federal income tax in 1966. This report focuses primarily on the individual or personal AMT.

Since many small businesses are organized as S corporations, sole proprietorships, and partnerships the personal AMT is of direct interest. These entities do not have “retained earnings” as all income is passed through to the owners. The owner’s own “after tax” income is, in effect, the “retained earnings” that they often put back into the business. Therefore, paying the personal AMT reduces the amount of income available to those owners to reinvest in their businesses.

The numbers of taxpayers who are affected by the AMT and the revenues that are collected because of it have been growing over time. In 2002, about 2 million taxpayers paid additional taxes because of the AMT. At the beginning of 2010, the Congressional Budget Office (CBO) released new numbers on the impact on taxpayers. The number of taxpayers affected by the AMT will increase from four million in calendar year 2009 to 27 million in 2010. Sixteen
percent of all taxpayers—and 36 percent of married couples—will be affected by the AMT in 2010. Said the CBO, “If nothing is changed this year, one in six taxpayers will be affected by the AMT, paying on average an additional $3,900 in tax, and nearly every married taxpayer with income between $100,000 and $500,000 will owe some alternative tax.”

The types of taxpayers who are affected by the AMT are changing over time. Historically, many of those subject to it were the relatively small number of filers who used a narrow set of tax preferences that were not allowed under the alternative tax. (For example, relatively few taxpayers are eligible for incentive stock options, which receive less favorable treatment under the AMT than under the regular income tax.) In the years to come, however, the preferences that are not allowed under the AMT, and that will move taxpayers within its sphere, are some of the more widely used features of the regular tax, such as the personal exemption (which is used by all taxpayers) and the standard deduction (which is used by roughly two-thirds of filers). The AMT potentially affects almost all filers who itemize because they generally claim a deduction for state and local taxes, which is not allowed under the AMT. That broad reach of the tax suggests that taxpayers in larger families (who have a greater number of personal exemptions) and taxpayers with larger deductions for state and local taxes will tend to be affected more by the AMT than will other taxpayers.

Unlike the parameters of the regular tax, the parameters of the AMT are not indexed for inflation. Under the regular tax, the personal exemption, standard deduction, and rate brackets are all indexed, which prevents tax rates from rising when incomes just keep pace with inflation. By contrast, the parameters of the AMT—the exemption and rate brackets—are not indexed. Over time, taxpayers face higher tax rates under the AMT, even if their incomes grow only at the pace of overall price rises. Because inflation boosts tax rates under the AMT but does not raise rates under the regular income tax, as prices rise, a greater number of taxpayers will owe more under the AMT than under the regular tax. In addition, the effects of inflation on the AMT accumulate over time. Prior to the economic turmoil, the Congressional Budget Office (CBO) had estimated that if the current law remained in effect, 70 percent of taxpayers in 2050 would be affected by the AMT, and the additional revenues from it would account for 20 percent of the personal income taxes collected by the government.

OUTLOOK

While the permanent patch eliminates the annual drama, there are still many taxpayers that will find themselves subject to the AMT. One would hope if Congress does debate the merits of tax reform, it would find a different way to generate revenue.