

An Analysis of the AMT and Suggested Fixes

To the Editor:

Much has been written lately in *Tax Notes* and by Nina Olson, IRS National Taxpayer Advocate, in her annual report, about the alternative minimum tax. Most commentators say that it will affect millions of taxpayers. Although that is true, it appears from the following calculations that a tax designed to stop wealthy taxpayers from avoiding the income tax altogether is now a mandatory tax for those upper-middle-income taxpayers caught in the wrong tax brackets, not a tax on the rich.

To test that theory I calculated the 2004 tax liability of a married couple with a preteen child and a teenage child and assumed that they had taxable income of \$100,000 after the standard deduction and personal exemptions. That amount was increased in \$100,000 taxable-income increments up to \$1,000,000.

The resulting calculations indicated that only those taxpayers with \$200,000 of taxable income were subject to the AMT. The interesting thing is that they were subject to the AMT even though they did not have any itemized deductions, adjustments, or preferences. The taxpayers were subject to the tax simply because of the interplay of the two tax schemes. On further investigation, it appears that the hypothetical taxpayer with no itemized deductions will start paying the AMT at \$191,150 of gross income and will move out of the AMT at \$234,051 of gross income.

An alternative calculation was also made using the same adjusted gross income but allowing for only one itemized deduction. That deduction was the payment of the current year's California income tax on the same income. Of course, many taxpayers would also have tax on their cars and taxes on their real estate, plus miscellaneous itemized deductions. But this example illustrates what would happen if they rented and didn't own a car. In that case the AMT hits the family of four between approximately \$186,850 and \$455,700 of gross income, effectively negating much, if not all, of the benefits of the state tax deduction and all other deductions that are not allowed for AMT purposes. Similar ranges will apply to citizens of high-income-tax states, high-property-tax states, or both.

If the numbers are correct, they point to two ways for those taxpayers to save money. Stop paying for year-end tax-planning advice and stop prepaying state and local taxes and other nondeductible AMT items. If you are subject to the AMT even without paying any tax, deferral of nondeductible AMT items is always the best course of action. Of course the problem is that the

system is not that simple. The numbers are based on gross income and taxable incomes without deductions. In addition, most of those taxpayers will owe state and local income and property taxes that will subject them to penalties if the taxes are not paid on a timely basis. So deferral is not always possible. Moreover, once deferral, such as for the fourth-quarter state estimate is made, subsequent years will start out with a non-deductible state income tax payment on January 15. The next year becomes even more likely to be an AMT year.

There does not appear to be much more one can do to avoid the AMT, except to earn a lot more income or move to a low-tax state. But Congress can change the law.

My suggestion for fixing the AMT problem is to make the following changes:

1. Lower the AMT rate by replacing the current 26 percent and 28 percent rates with a flat 15 percent rate, the same rate used for dividends and capital gains.
2. Do not phase out the exemption.
3. Allow state and local income taxes as an AMT deduction.
4. Allow a deduction for real estate taxes in a similar manner as interest is allowed — for personal residences, on up to two houses with values up to \$1,100,000 and for investment property 100 percent, limited to investment income less investment interest expenses.
5. Allow a miscellaneous itemized deduction (after the 2 percent reduction) for all attorney fees, but only if an election is made to deduct those fees in the year of collection or settlement. Require similar treatment for all taxpayers, regardless of state.
6. Adopt one modified accelerated cost recovery system depreciation schedule for both regular federal tax and for the AMT.
7. Incentive stock options should be excluded from the AMT.

If those changes are implemented, there will still be an AMT to protect the tax system, but it will apply only to taxpayers who should really pay it, those whose tax liability falls below 15 percent.

Sincerely,

Richard Malamud, Professor
California State University,
Dominguez Hills
Carson, Calif.

COMMENTARY / LETTERS TO THE EDITOR

	100,000	200,000	300,000	400,000	500,000	600,000	700,000	800,000	900,000	1,000,000
Case 1										
Taxable Income										
AGI	122,100	221,356	312,180	409,700	509,700	609,700	709,700	809,700	909,700	1,009,700
Deductions	(9,700)	(9,700)	(9,700)	(9,700)	(9,700)	(9,700)	(9,700)	(9,700)	(9,700)	(9,700)
Exemptions	<u>(12,400)</u>	<u>(11,656)</u>	<u>(2,480)</u>	=	=	=	=	=	=	=
Taxable Income	<u>100,000</u>	<u>200,000</u>	<u>300,000</u>	<u>400,000</u>	<u>500,000</u>	<u>600,000</u>	<u>700,000</u>	<u>800,000</u>	<u>900,000</u>	<u>1,000,000</u>
Regular Tax	18,475	47,025	80,025	114,643	149,643	184,643	219,643	254,643	289,643	324,643
AMT	—	210	—	—	—	—	—	—	—	—
Credit	<u>(350)</u>	=	=	=	=	=	=	=	=	=
Total Tax	<u>18,125</u>	<u>47,235</u>	<u>80,025</u>	<u>114,643</u>	<u>149,643</u>	<u>184,643</u>	<u>219,643</u>	<u>254,643</u>	<u>289,643</u>	<u>324,643</u>
AMT Calculation										
Regular Income	122,100	221,356	312,180	409,700	509,700	609,700	709,700	809,700	909,700	1,009,700
AMT Exemption	<u>(58,000)</u>	<u>(40,161)</u>	<u>(17,455)</u>	=	=	=	=	=	=	=
AMTI	<u>64,100</u>	<u>181,195</u>	<u>294,725</u>	<u>409,700</u>	<u>509,700</u>	<u>609,700</u>	<u>709,700</u>	<u>809,700</u>	<u>909,700</u>	<u>1,009,700</u>
Tentative AMT	<u>16,666</u>	<u>47,235</u>	<u>79,023</u>	<u>111,216</u>	<u>139,216</u>	<u>167,216</u>	<u>195,216</u>	<u>223,216</u>	<u>251,216</u>	<u>279,216</u>
Federal Tax Rates										
Effective Total Tax Rate	14.84%	21.34%	25.63%	27.98%	29.36%	30.28%	30.95%	31.45%	31.84%	32.15%
Marginal Tax Rate	14.84%	29.33%	36.10%	35.50%	35.00%	35.00%	35.00%	35.00%	35.00%	35.00%
Federal AMT Rates										
AMT Effective Rate	13.65%	21.34%	25.31%	27.15%	27.31%	27.43%	27.51%	27.57%	27.62%	27.65%
AMT Marginal Rate	13.65%	30.80%	35.00%	33.01%	28.00%	28.00%	28.00%	28.00%	28.00%	28.00%
Case 2: Same example with California tax as the only itemized deduction										
California Tax on above	6,273	15,504	24,319	33,698	42,998	52,298	61,598	70,898	80,198	89,498
Taxable Income										
AGI	122,100	221,356	312,180	409,700	509,700	609,700	709,700	809,700	909,700	1,009,700
Itemized or Standard Deduction	(9,700)	(13,144)	(19,235)	(25,688)	(31,988)	(38,288)	(44,588)	(50,888)	(57,188)	(63,488)
Exemptions	<u>(12,400)</u>	<u>(11,656)</u>	<u>(2,480)</u>	=	=	=	=	=	=	=
Taxable Income	<u>100,000</u>	<u>196,556</u>	<u>290,465</u>	<u>384,012</u>	<u>477,712</u>	<u>571,412</u>	<u>665,112</u>	<u>758,812</u>	<u>852,512</u>	<u>946,212</u>
Regular Tax	18,475	45,888	76,878	109,047	141,842	174,637	207,432	240,227	273,022	305,817
AMT	—	1,347	2,145	2,169	—	—	—	—	—	—
Credit	<u>(350)</u>	=	=	=	=	=	=	=	=	=
Total Federal Tax	<u>18,125</u>	<u>47,235</u>	<u>79,023</u>	<u>111,216</u>	<u>141,842</u>	<u>174,637</u>	<u>207,432</u>	<u>240,227</u>	<u>273,022</u>	<u>305,817</u>
AMT Calculation										
AMTI	64,100	181,195	294,725	409,700	509,700	609,700	709,700	809,700	909,700	1,009,700
Tentative AMT	16,666	47,235	79,023	111,216	139,216	167,216	195,216	223,216	251,216	279,216
Total Tax (Federal + California)										
Federal Tax	18,125	47,235	79,023	111,216	141,842	174,637	207,432	240,227	273,022	305,817
California Tax	<u>6,273</u>	<u>15,504</u>	<u>24,319</u>	<u>33,698</u>	<u>42,998</u>	<u>52,298</u>	<u>61,598</u>	<u>70,898</u>	<u>80,198</u>	<u>89,498</u>
Total Tax	<u>24,398</u>	<u>62,739</u>	<u>103,342</u>	<u>144,914</u>	<u>184,840</u>	<u>226,935</u>	<u>269,030</u>	<u>311,125</u>	<u>353,220</u>	<u>395,315</u>
Federal Tax Rates										
Federal Effective Rate	14.84%	21.34%	25.63%	27.98%	29.36%	30.28%	30.95%	31.45%	31.84%	32.15%
Federal Marginal Rate	14.84%	29.33%	36.10%	35.50%	35.00%	35.00%	35.00%	35.00%	35.00%	35.00%

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COMMENTARY / LETTERS TO THE EDITOR

	100,000	200,000	300,000	400,000	500,000	600,000	700,000	800,000	900,000	1,000,000
Federal AMT Tax Rates										
AMT Effective Rate	13.65%	21.34%	25.31%	27.15%	27.31%	27.43%	27.51%	27.57%	27.62%	27.65%
AMT Marginal Rate	13.65%	30.80%	35.00%	33.01%	28.00%	28.00%	28.00%	28.00%	28.00%	28.00%
Total Tax Rates Paid										
Fed + CA Effective Rate	19.98%	28.34%	33.10%	35.37%	36.26%	37.22%	37.91%	38.42%	38.83%	39.15%
Fed + CA Marginal Rate	19.98%	38.63%	44.71%	42.63%	39.93%	42.10%	42.10%	42.10%	42.10%	42.10%

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