

Inflation and the Individual AMT

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===== SUMMARY =====

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===== FULL TEXT =====

[1] A minimum tax has been part of individual income taxation since the enactment of the individual add-on minimum tax in 1969. /1/ The current individual alternative minimum tax (AMT) underwent major revisions with the Tax Reform Act of 1986 (TRA '86). In making the 1986 modifications, "Congress concluded that the minimum tax should serve one overriding objective: to ensure that no taxpayer with substantial economic income can avoid significant tax liability by using exclusions, deductions, and credits." /2/ From the legislative history, it is clear that the focus of the AMT has been on high-income taxpayers.

[2] Each year, however, the AMT is catching more and more taxpayers who are not wealthy and do not have what are commonly thought of as tax preferences. The AMT tax base includes both "preferences" and "adjustments" to broaden its tax base. The adjustments include items such as the standard deduction, personal and dependency exemptions, and a subset of itemized deductions -- most notably state and local taxes. In the past, the individual AMT exemption /3/ has mitigated the effect of having to include these adjustments in the AMT tax base.

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[3] Over time, inflation combined with regular income tax (RIT) bracket and exemption indexing has eroded the value of this exemption. As each year passes, the AMT is shifting from a tax burden for high-income taxpayers to one for moderate-income taxpayers. Robert Harvey and Jerry Tempalski /4/ indicate that in 1997 taxpayers with AGI less than \$200,000 represented 68 percent of the AMT returns and paid 28 percent of the AMT. They project that this group of taxpayers will be filing 83

percent of the AMT returns and paying 50 percent of the tax by 2007.

[4] The relationship between inflation and the AMT is complex. David Hulse /5/ gives some insight into current AMT issues with his AMT boundary calculations. These boundaries derive the breakeven points to determine how much in preferences and adjustments taxpayers at varying taxable incomes may have before being subject to the AMT under current law. Over time, inflation causes these breakeven points to decline. Figure 1 depicts the breakeven point for AMT preferences and adjustments for a married filing joint taxpayer assuming that the only exemptions claimed are the personal exemptions for the taxpayer and spouse. /6/ The top line depicts the breakeven points under 1998 law. For example, assume that a taxpayer and spouse have taxable income of \$100,000. The graph shows that the AMT preference and adjustment breakeven point under current law is approximately \$26,000. /7/ Thus, these married taxpayers could claim up to that amount of adjustments or preferences in addition to their personal exemptions before having to pay the AMT.

FIGURE 1
AMT BREAKDOWN POINTS UNDER DIFFERING
INFLATION RATES

[figure omitted]

[5] The curves below the current law curve depict AMT preference and adjustment breakeven points under differing assumptions of cumulative inflation. /8/ Figure 1 shows that the breakeven points decline with inflation for all but the very lowest of taxable income levels. It is also apparent that moderate-income taxpayers have some of the

lowest breakeven points. This is a result of the interaction of the AMT and RIT tax bases and their rates. The AMT tax base is broader than that for the RIT and is taxed at a marginal tax rate of 26 or 28 percent. At the lowest RIT marginal tax rate of 15 percent, the AMT exemption functions to give the larger breakeven points for taxpayers with the lowest taxable incomes. One can observe, however, that as the 15 percent RIT bracket widens with inflation indexing, the breakeven points decline precipitously. When the RIT marginal tax rate rises to 28 percent and the AMT marginal tax rate stays at 26 percent, the breakeven points begin to rise slightly. The breakeven points resume declining with the AMT exemption phaseout. The breakeven points do not begin to rise again until the RIT marginal tax rate rises above 28 percent. In addition, the rate of increase in the breakeven point goes up as the regular marginal income tax rate increases. From Figure 1, there appears to be a range of taxable income at which the marginal tax rates for the RIT and AMT are nearly equivalent, and the AMT exemption may eventually not provide enough of a wedge to keep even those taxpayers without preferences from paying the AMT.

Inflation, the AMT, and Dependency Exemptions

[6] One could conclude from Figure 1 that it will take a number of years for moderate-income taxpayers to face the AMT. Figure 1 assumes, however, that the only adjustments claimed are two personal exemptions. How do the projections differ when one adds additional dependency exemptions, the standard deduction or common itemized deductions such as state and local taxes? Since these items increase with inflation, taxpayers with these items may face the AMT much sooner.

[7] Figure 2 gives some insight into predicting what types of taxpayers will face paying the AMT and when they might have to pay it. The graph shows how much cumulative inflation would have to occur before married filing joint taxpayers with differing types of adjustments would have to pay the AMT. It includes calculations for taxpayers with taxable incomes between zero and \$100,000 since this includes the vast majority of taxpayers. It also focuses on settings in which taxpayers would have to pay the AMT as a result of AMT adjustments rather than preferences. The curve labeled "no dependents with standard deduction" calculates breakeven inflation rates for the scenario graphed in Figure 1. For example, Figure 2 indicates that a married filing joint taxpayer with \$50,000 of taxable income, no dependency exemptions, and claiming only the standard deduction would not face the AMT until the cumulative inflation rate becomes approximately 90 percent. /9/ Another way of interpreting this result is that a cumulative inflation rate of 90 percent would cause the curve in Figure 1 to drop through the horizontal axis at a taxable income of \$50,000.

FIGURE 2 BREAKEVEN CUMULATIVE INFLATION RATES FOR MARRIED FILING JOINT TAXPAYERS

[figure omitted]

[8] Figure 2 also displays curves for taxpayers with different numbers of dependents or with a deduction for state and local taxes. One can observe that as the number of dependency exemptions increases, the required cumulative inflation rate becomes closer and closer to levels that will be reached soon. For example, a married filing joint taxpayer with \$50,000 of taxable income, four dependents, and only the standard deduction will reach AMT territory once the cumulative inflation rate becomes approximately 10 percent. Without any inflation, the curve for joint filers having six dependents and claiming the standard deduction are subject to AMT at \$38,525 of taxable income and will not rise out of the AMT until they reach \$63,380 of taxable income. These taxpayers already must pay the AMT! Certainly, they were not the original targets for the AMT.

[9] Figure 2 also shows a curve for joint filers having two dependents who itemized a state and local tax deduction. State and local taxes as well as miscellaneous itemized deductions above the 2 percent floor are AMT adjustments. State and local taxes tend to rise as incomes rise. Estimates of state and local taxes are derived using Statistics of Income data. /10/ At lower levels of taxable income, the estimated state and local tax deduction is less than the standard deduction. Because there is less of an adjustment, a greater degree of cumulative inflation is required before these taxpayers pay the AMT. If one compares the curves for the taxpayers having two dependents and a state and local tax deduction to that for taxpayers having two dependents and a standard deduction, they intersect where the estimated state and local tax deduction becomes equal to the standard deduction. At higher levels of taxable income, state and local tax deductions frequently exceed the standard deduction, and taxpayers at those levels face an increasing probability that they will have to pay the AMT sooner. By extrapolating this analysis to high-tax states, one can conclude that taxpayers with modest-sized families living in high tax states soon will have to pay the AMT.

[10] The AMT is drifting toward taxing a group of taxpayers for which it was not originally intended. Each year, more and more taxpayers are finding themselves having to pay a tax that in some cases they did not even know existed. For those that would like to have a flat tax, this is a means of implementing one through the back door. If the AMT continues in its current form, serious consideration needs to be given to the policy implications

of making the AMT potentially the primary tax base rather than a tax base for only a relatively few wealthy taxpayers.

FOOTNOTES

/1/ For a review of the history and policy implications of shifts in the corporate and individual alternative minimum taxes, see Karlinsky, Stewart, "A Report on Reforming the Alternative Minimum Tax System," 12 American Journal of Tax Policy 139.

/2/ Staff of the Joint Committee on Taxation, General Explanation of the Tax Reform Act of 1986 (P.L. 99-514, October 22, 1986, H.R.3838, 99th Congress), pp. 432-433.

/3/ The exemption is \$33,750 for single individuals but rises to \$45,000 for joint filers (but is only \$22,500 for a married person filing separately).

/4/ Harvey, Robert P. and Jerry Tempalski, "The Individual AMT: Why It Matters," National Tax Journal, September 1997, pp.453-473.

/5/ Hulse, David, "AMT Boundaries for Individuals in 1998," Tax Notes, Sept. 28, 1998, p. 1598.

/6/ These breakeven points incorporate both the AMT exemption and regular income tax personal exemption phase-outs.

/7/ The precise breakeven point is \$26,117. This is confirmed with the following calculation. The regular income tax on \$100,000 under 1998 law is $(\$6,352.5 + .28 \times (\$100,000 - \$42,350)) = \$22,494.50$. The breakeven calculation indicates that these taxpayers could have \$26,117 in adjustments and preferences in addition to the two personal exemptions that they are already claiming. The AMT tax liability under these assumptions would be $(.26 \times (\$100,000 - \$45,000 + 26,117 + 2(\$2,700))) = \$22,494.42$. Hulse calculates a breakeven point of

\$31,518 because he does not assume that the taxpayer is already claiming two personal exemptions. If one adds the two personal exemptions that the married filing joint taxpayers are assumed to claim in these curves to the calculated breakeven point, one obtains a result that is similar to Hulse's $(\$26,117 + 2(\$2,700)) = \$31,517$. The difference is the result of rounding in the formulas used to derive the breakeven points.

/8/ In deriving these curves, regular income tax brackets, standard deductions, and exemptions were indexed for inflation.

/9/ This is verified with the following calculation. The breakeven inflation rate is actually 90.77 percent. With inflation bracket indexing, the 15 percent bracket would be extended to include \$50,000. Thus, the regular income tax would be: $.15 \times \$50,000 = \$7,500$. The personal exemptions would grow to be: $2(\$2,700)(1.9077) = \$10,301.58$. The standard deduction would grow to be: $\$7,100(1.9077) = \$13,544.67$. Thus, the AMT would be: $.26 \times (\$50,000 + \$13,544.67 + \$10,301.58 - \$45,000) = \$7,500.03$.

/10/ Data from the Internal Revenue Service, Statistics of Income Bulletin, Fall 1997, p. 35, were used to estimate a regression equation to estimate state and local taxes at a given level of taxable income. The data used to estimate this equation show state and local tax deductions claimed for levels of adjusted gross income (AGI). The average state and local taxes claimed per return for an AGI level is used as a dependent variable. The midpoint of the AGI income range is the independent variable. The estimated regression is: $TAXDED = 965.58 + .05745 * AGI$ (Adjusted R ² = .987). Estimates of state and local taxes for each point on the curve are derived based on this estimated regression.

END OF FOOTNOTES

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