Special Report

SR1-05
April 2005

Another Middle-class Tax?

How the Federal AMT Hits New Yorkers

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FOR NEW YORK STATE POLICY
A project of the Manhattan Institute for Policy Research

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EXECUTIVE SUMMARY

Federal income tax cuts enacted during the past four years have been particularly beneficial to New York, saving Empire State residents a total of $36 billion through 2004. However, as documented in this report, New Yorkers are also being hit harder than most Americans by what's been called "the most serious problem faced by federal taxpayers"[1] — the Alternative Minimum Tax (AMT).

Created 36 years ago as a way to curb tax avoidance by the wealthiest Americans, the AMT now threatens to become ***A***nother ***M***iddle-class ***T***ax. Its recent spread has been concentrated among married couples with children in New York and other places with high living costs and heavy state and local tax burdens.

The Manhattan Institute's tax model supports these findings about AMT incidence and liability in the Empire State:

- The AMT will boost the 2004[2] tax bills of affected New York state residents by $2.6 billion, roughly 15 percent of the estimated U.S. total. More than half the state's AMT payments were owed by residents of New York City.
- 332,000 New York taxpayers had to pay the AMT in 2004, nearly double the number affected in 2000. This included roughly 144,000 tax filers in New York City.
- With less than 7 percent of the nation's individual taxpayers, New York State was home to about 12 percent of all AMT filers.
- Additional AMT liability effectively stole away 38 percent of the recent tax cut savings for New York households earning between $150,000 and $500,000.[3]
- Although the AMT currently affects only 4 percent of all New York State taxpayers, the proportion rises to roughly one-third of all New York families with incomes above $100,000. Given the AMT's design quirks, those affected consist predominantly of families with children, especially in New York City and its suburbs.
- In 2006, if federal law remains unchanged, the number of AMT payers in will expand sixfold nationally and approach 1.6 million New York filers — including nearly half of all households earning between $50,000 and $200,000.
- By 2010, again assuming no change in current law, the AMT will hit fully one-quarter of all New York taxpayers and most of the state's middle-class families.

Once a technical issue appreciated mainly by tax preparers and policy experts, the AMT problem is receiving increasing public attention as the President's Advi-

sory Panel on Federal Tax Reform hears testimony on necessary changes in the tax code. But given the huge budget impact, there is no guarantee that the problem will be resolved permanently, or at all.

Given the current AMT over-reach in New York, this report underscores that preserving the *status quo* is not good enough. Only the limitation or radical revision of the AMT will ensure that taxpayers in New York and other states will be treated fairly.

TAX CUTS AND THE AMT

President George W. Bush has initiated a series of substantial cuts in individual income taxes over the past four years.

The tax-cutting began in 2001 with the Economic Growth and Tax Relief Reconciliation Act (EGTRRA), which enacted a multi-year, phased in cut in rates for every income bracket, starting in the lowest income brackets the year the law was passed. EGTRRA also doubled the child credit on a phased-in basis, from $500 to $1,000, and eliminated the so-called marriage penalty for working couples.

The phase-in schedule for the 2001 cuts was accelerated two years later in the Jobs and Growth Tax Relief and Reconciliation Act of 2003 (JGTRRA), which also slashed tax rates on income from capital gains and dividends.

These tax cuts boosted the nation's recovery from the recession of 2001 and, if anything, were even more beneficial to the investment-intensive economy of New York. The Empire State's share of the total tax savings has totaled $36 billion, including $14 billion in 2004 alone. For residents of New York City, the savings have amounted to $15 billion cumulatively and $6 billion a year, respectively.[4]

Paradoxically, however, the lower rates ushered in by the federal tax changes also tend to push more families into territory originally intended to be the exclusive preserve of the super-rich -- the Alternative Minimum Tax (AMT).

Dual tax systems

Most New Yorkers, like most Americans, probably still don't know that they are potentially subject to two different methods of calculating their federal income taxes—the regular tax and the AMT. The final tax bill must reflect the highest amount yielded by the two approaches.

This system was created in 1969, a few years after it was disclosed that a handful of Americans with incomes exceeding the then stratospheric level of $200,000 a year (over $1 million in 2005 terms) had managed to avoid paying any income taxes. The AMT was designed to ensure that these wealthy files would always owe some tax, no matter how successfully they tried to "shelter" all of their income.

However, because its design was never altered to reflect the fundamental changes in tax policy enacted since 1981, by the end of the 1990s the AMT has already spread far beyond its originally targeted population and was poised to afflict a growing number of middle-class taxpayers in the near future.

To understand how the alternative tax affects taxpayers, it's important to keep in mind that:

- The AMT does not allow deductions for personal exemptions.
- The AMT does not allow itemized deductions for, among other things, state and local taxes.
- The AMT brackets do not vary by marital status, and the exemption for couples is less than double the exemption for singles.[5]

These features of the law mean the AMT is more likely to hit married couples with children. Families in New York are especially likely to be affected, because they have relatively high incomes (reflecting high living costs) and claim larger than average deductions for state and local taxes.

Under the AMT, all income above a "unified exemption"—set at $58,000 for married couples and $40,200 for most other taxpayers from 2003 through 2005 —is taxed at a starting rate of 26 percent. A rate of 28 percent kicks in on incomes above $175,000. However, the exemption itself begins to phase out for married couples with AMT taxable income above $150,000, and is eliminated for income above $382,000.[6] This effectively raises the AMT marginal rate (the tax paid on each additional dollar of income) to 32.5 percent and 35 percent, respectively. Under the regular income tax, by comparison, married joint filers are subject to a 25 percent marginal rate on taxable incomes up to 117,000, and 28 percent on taxable income up to $178,650. The 35 percent regular income tax rate doesn't kick in until incomes exceed $315,000.

In other words, for most of the filers affected by it, the AMT taxes *more* income at a *higher* marginal rate than the regular tax code. To ameliorate this effect, both the 2001 and 2003 tax cuts raised the unified exemption amount. However, to hold down the long-term "cost" of the cuts under congressional budget-scoring rules, the AMT relief provisions are scheduled to expire at the end of 2005.

The income brackets and the exemptions under the regular tax code are indexed to rise with inflation, but the AMT parameters are not. As a result, the AMT is not just a floor but a *rising* floor relative to regular taxes. Over time, more and more people have found themselves paying it—or, at the very least, having to fill out a lengthy form to determine whether they have to pay it or not.

By further reducing rates and by stretching tax brackets for married couples, the recent federal tax cuts will (a) save millions of taxpayers thousands of dollars a year while (b) turning more of them into AMT filers, or increasing their existing AMT liability, and thus reducing the tax savings that they would otherwise realize as a result of the cuts.

Given the extraordinary complexity of the Alternative Minimum Tax, and its pernicious way of sneaking up on unsuspecting taxpayers, a leading tax expert has suggested that the letters AMT could just as well stand for "Always Means Trouble."[7] The first time some taxpayers learn they owe an AMT payment is when the IRS charges them a penalty for having failed to make it.

A case study illustrating how the AMT interacts with the regular tax for many New York families is presented in Box 1. In this case, as shown, the AMT adds $600 to the family's tax bill. But if the temporarily AMT revisions expire on schedule, the AMT tax bill for such a family will jump to nearly $4,000 a year, more than canceling out all of the tax savings created by the 2001 and 2003 tax acts.

The impact in New York

As noted, the AMT's design indicates it is most likely to entangle married couples with multiple dependents in high-tax states. However, few studies have been done to estimate the impact of AMT on specific state populations. Prior to 2001, the most thorough and authoritative look at the AMT was a 2000 paper by the Treasury Department's Office of Tax Analysis, which estimated that a small group of high-tax states, including New York, accounted for 55 percent of all AMT payers. [8]

More recent studies Congressional Budget Office[9], and by researchers at the Tax Policy Center of the Brookings Institution and the Urban Institute[10], have estimated that the AMT hits about 3 million tax filers across the country in 2004, but that this number will rise to 30 million or more by 2010 if current laws remains unchanged.

The Manhattan Institute's tax policy model[11] produces results consistent with these projections. As shown in Box 2, the model finds that 332,000 New York tax filers paid the AMT in 2004, including 144,000 filers in New York City. This is 12 percent of the model's estimated total for the nation as a whole. Although the model does not estimate tax impacts in other states, the New York data would tend to support the assumption that AMT payers currently remain concentrated in the same jurisdictions identified as AMT hotbeds in the Treasury Department's 2000 report. In addition to New York, these would include California, Connecticut, Maryland, Massachusetts, Minnesota, New Jersey, Oregon, Rhode Island and Wisconsin, plus the District of Columbia.

If the AMT exemption remains fixed at current levels, the number of AMT payers and AMT liability will grow steadily through the end of the decade. But if the exemption reverts to its old levels starting in calendar year 2006, as scheduled under current law, there will be a dramatic rise in the number of AMT filers and the amount owed under the tax – as illustrated in Figure 1 on page 6 and detailed in Box 2 on page 7. In 2006, the number of AMT payers in New York will jump to nearly 1.6 million, and will increase by another 800,000 filers through the end of the decade. New Yorkers' AMT liability will rise, too – from an estimated $3 billion in 2005 to $6.7 billion in 2006, to $11 billion by 2010.

Box 1

Calculating the AMT: A Case Study

To understand how the Alternative Minimum Tax works, consider the example of a married couple with three children (two under 17) and income of $140,000, all in wages, as of 2004.

This couple paid $10,000 in mortgage interest and $16,000 in state and local taxes, and made $2,000 in charitable contributions. In most parts of the United States, an income of $140,000 would be seen as affluent, or at least upper middle class. But by downstate New York standards, their income and other characteristics would place this family within the definition of middle-class; for example, it could represent a police sergeant married to a nurse.

After subtracting their personal exemptions and itemized deductions, the family's taxable income under the regular income tax, as shown on the left side of the table below, is $96,500. As illustrated by the calculations, this yields a tax of $17,600. This represents a $2,750 savings from what they would have paid under the old, pre-2001 tax law.

Under the AMT, as shown on the right side of the table, the couple loses the ability to claim personal exemptions and itemized deductions of state and local taxes, although they can still subtract mortgage interest and charitable contributions, leaving them with an AMT taxable income of $128,000. Applying the 26 percent rate to the resulting amount yields tax is $18,200. They must pay the difference between this amount and their regular tax, or $600. Thus, the AMT not only adds to the this family's federal tax bill for 2004, it is equivalent to 22 percent of the value of the tax cut the family was entitled to under post-2001 changes to the law.

A note on things to come: under current law, the AMT exemption is supposed to return to its permanent level of $45,000 in 2006. If that happens, a family with this same profile would pay the AMT rate on an additional $13,000 of income, pushing up their AMT payment to $21,580. This would add $3,980 to their regular tax bill, wiping out *all* of their tax cut — and then some.

AMT Calculation

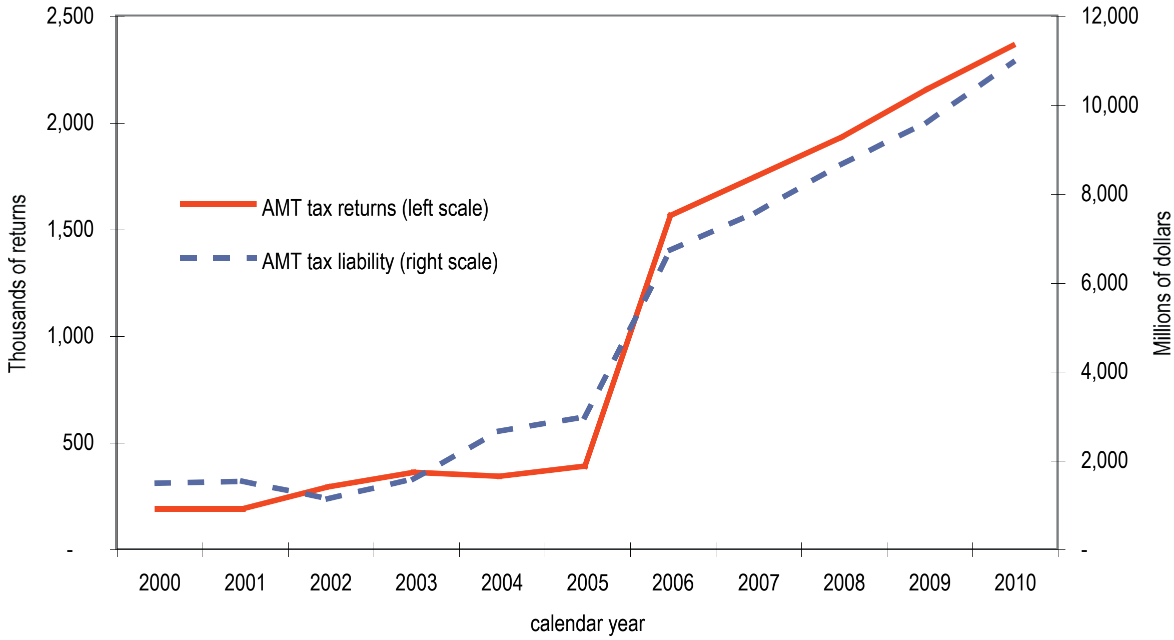
(Dollars)

2004 Regular Tax		2004 Alternative Minimum Tax	
Income	140,000	Income	140,000
Minus exemption: 5 x 3,100	-15,500	Minus mortgage interest	-10,000
	124,500	Minus charitable contributions	-2,000
Minus mortgage interest	-10,000		128,000
Minus state and local taxes	-16,000	Minus AMT exemption	-58,000
Minus charitable contributions	-2,000		
Taxable Income	96,500	AMT Taxable Income	70,000
Tax Computation		AMT	
10 percent of income up to 14,300	1,430	26 percent of taxable income	18,200
15 percent of the next 43,800	6,570		
25 percent of income up to 117,250	9,600	Minus Regular Tax	-17,600
Regular Tax*	17,600	AMT Liability*	600

* Before child credit of $500

Source: Manhattan Institute calculations based on 2004 tax parameters

Figure 1
Estimated and Projected AMT Impact in New York State



Source: Manhattan Institute-Fiscal Economics Inc. microsimulation model

Box 4 on page 9 shows how many New York taxpayers in different income groups are currently affected by the AMT, and how their numbers may grow in future years.

As of 2004, 20 percent of all filers between $100,000 and $200,000 paid the AMT, jumping to 83 percent of filers in the $200,000 and $500,000. But the AMT affected only a minority of filers in upper-income brackets.

But if current law remains unchanged, in 2006 the AMT will become the norm for all taxpayers earning between $100,000 and $500,000. Significant numbers of households earning between $50,000 and $100,00 will also begin paying the tax. By the end of the decade, the AMT will affect 40 percent of New Yorkers earning between $50,000 and $100,000. At that point, given current wage and inflation trends, the AMT will affect the vast majority of all families with children in the New York State.

Statewide, New York taxpayers earning between $150,000 and $500,000 lost 38 percent of the value of their recent federal tax cuts to increased AMT taxes in 2004, according to the Manhattan Institute model. The percentage was higher in New York City, where the AMT hits more of these taxpayers.

Most of the state's $2.6 billion in AMT liability as of 2004 was owed by filers earning over $200,000. But under current law, the liability will shift down the income scale -- so that in 2006, nearly half the AMT payments will be due from taxpayers earning less than $200,000.

Box 2
AMT Filers and Liability, 2004 through 2010

(dollars in millions)

	U.S. Total		New York State		New York City	
	Returns	Liability	Returns	Liability	Returns	Liability
2004	2,880,249	$16,924	332,031	$2,610	143,581	$1,356
2005	3,419,160	$19,475	379,499	$2,934	166,049	$1,530
2006	19,697,363	$68,986	1,554,338	$6,685	601,070	$3,410
2007	22,070,429	$79,369	1,737,846	$7,535	661,443	$3,806
2008	24,705,868	$93,411	1,921,375	$8,618	717,745	$4,321
2009	27,894,933	$104,244	2,146,944	$9,561	790,393	$4,707
2010	30,615,415	$121,668	2,350,518	$10,907	856,635	$5,326

Source: Manhattan Institute-Fiscal Economics, Inc. microsimulation model

WHAT CAN BE DONE ABOUT IT?

If the current unified exemption was extended through the end of the decade, both the number of AMT filers and their AMT liability would continue rising, but at a much slower rate.

But maintaining the current law is by no means a preferable option for states like New York, whose residents already bear a disproportionate share of the burdens associated with filing the AMT. (See Box 3, "How the AMT Affects One New York Family," on page 8.)

Nina B. Olsen, the National Taxpayer Advocate, told Congress in 2004 that "the need for AMT relief looms like the proverbial elephant in the room."[12] Like many policymakers who have seriously studied and considered the impact of the law, she recommended complete repeal of the AMT as the best solution. Assessed on a static basis, according to the Manhattan Institute's model, this would reduce federal revenues by nearly $70 billion – not including any offsetting economic gains from simplifying the tax code and removing disincentives to earn and invest. Merely extending existing relief provisions would have a static impact of $50 billion on budget revenues.

Assuming an immediate, outright repeal is considered unfeasible for fiscal reasons, alternatives include:

- Revising the AMT to allow personal exemptions and deduction of state and local taxes and
- Permanently indexing the unified exemption and exemption phase-out ranges to inflation.

Allowing personal exemptions would eliminate the AMT for about one-fifth of the taxpayers who would owe it under current law, according to the Congressional Budget Office.[13] Allowing the state and local tax deduction would eliminate the impact for another one-third, based on CBO' s analysis. Taken together, these changes would reduce the rolls of AMT payers by at least half, compared to current law. Applied to New York, that would mean there would be 1.15 million AMT filers.

But neither of these revisions would do as much to stem the growth of the AMT as linking its key provisions to inflation. As noted, the AMT unified exemption is now set at $58,000 for married couples and $40,200 for most others, and it is scheduled to revert to the much lower levels starting in 2006. The phase-out ranges for

Box 3

How the AMT Affects One New York Family

Thomas Rinaldi, a small business owner in Westchester County, is typical of many New York State residents affected by the Alternative Minimum Tax. The following are excerpts from his recent testimony before the President's Advisory Panel on federal tax reform:

"I have been paying the AMT for the past few years. I had not heard of the AMT before my accountant told me that I would owe additional taxes because we lost many of our tax benefits under this hidden separate tax. I was very surprised to find out that the tax code contains a stealth provision that snares taxpayers just because they claim deductions they are told they should be taking. I was even more surprised to find out that I would be forced to pay additional tax because of the AMT. No matter how many times I ask my accountant to explain it to me, I still can't figure out why I have to pay AMT even though I went to four years of college and minored in mathematics. The regular tax code is complicated enough; this surprise tax makes it even more confusing and causes me to spend more time and money figuring out my taxes …

"We fell into the AMT trap simply because we live in a high-tax state, own our own home and have three beautiful children. The AMT eliminated the deduction for income and property taxes that we pay in New York. The AMT also snatched away the five personal exemptions that we are given under the tax law.

"Like many other families in our area, we've worked hard to build a profitable small business and to make a decent living to support our family. My understanding is that the AMT was designed years ago to make sure that very wealthy taxpayers pay something in tax. I believe that everyone should pay their fair share, but I now know from personal experience that the AMT is hitting middle-class taxpayers like us. We're not wealthy and are not trying to avoid paying the tax we owe. So why should we be forced to hire somebody to compute our taxes twice and to pay more in tax?

"Over the past few years, the money our family paid in AMT reduced the amount we had left over to invest in our business, put away in savings, or spend on our children. The AMT is too complicated to understand, catches people by surprise, and reduces the amount of money that they have to plan for the future. I believe that as part of its effort to reform our tax code, the panel should study ways to stop the AMT from hitting middle-class American families like us."

Box 4

Percentage of New York State Taxpayers Filing AMT Returns

(percentages)

	calendar year						
Income Ranges	2004	2005	2006	2007	2008	2009	2010
Total	4	4	17	19	21	23	25
\$50,000 to \$100,000	1	1	30	32	34	38	40
\$100,000 to \$200,000	20	21	84	85	86	89	90
\$200,000 to \$500,000	83	85	94	95	96	96	97
\$500,000 to \$1,000,000	43	44	50	51	57	55	60
Over \$1,000,000	31	32	34	34	38	31	35

Source: Manhattan Institute-Fiscal Economics, Inc. microsimulation model

the exemption have remained fixed throughout the past five years.

Compared to simply extending all current AMT provisions through 2010, indexing the exemption and the phase-out range would prevent another 33,300 New Yorkers from having to pay the tax in 2005 and save state residents a total of \$100 million. By the end of the decade, compared to an extension of existing provisions, 310,000 fewer New York filers would avoid having to pay an AMT tax, saving taxpayers \$1 billion. An AMT fully indexed at 2004 levels would still affect about 400,000 New York filers in 2010.

CONCLUSION

In the short run, a continuation of temporary AMT relief provisions is the minimum acceptable outcome for taxpayers, especially in New York and other states most affected by the tax. But attempting to choose among other possible AMT revisions is ultimately a frustrating exercise in fiscal *triage*.

In the final analysis, *no* aspect of the AMT can be defended in combination with the existing tax law. The festering problem of the AMT and the threat it represents to the middle class is the best available argument for reform of the entire federal tax structure.

NOTES

[1] National Taxpayer Advocate, *Annual Report to Congress*, Publication 2104 (Rev. 12-2003).
[2] Unless otherwise specified, references to years mean calendar years, which are the same as individual tax years.
[3] All references to taxpayer incomes in this report are to "adjusted gross income" – the bottom line on the first page of every individual tax return. This includes all wages, salaries and net business income, while excluding some categories of income, including deposits in Individual Retirement Accounts.
[4] See E.J. McMahon, "The $36 Billion Bonus: New York's Gains from Federal Tax Cuts," Manhattan Institute for Policy Research, Civic Report 43, August 2004, available at http://www.manhattan-institute.org/html/cr_43.htm.
[5] Other features of the AMT, not extensively reviewed in this report, affect fewer individuals but do even more to distort behavior or to unfairly penalize. For example, among the AMT's most pernicious features is its treatment of incentive stock options (ISOs), an especially common form of compensation in small, growing companies. The AMT taxes the fair market value of stock at the time an option is exercised, and not at the time the stock is sold or at the end of the tax year. When the stock market slumped in 2001 and 2002, workers rewarded with ISOs during the boom were faced with huge AMT liabilities. Some families with five-figure incomes have gone bankrupt to pay six-figure tax bills for paper gains on their greatly devalued investments.
taxpayers.
[6] The phaseout range starts at $112,500 for single filers and at $75,000 for married couples filing separately.
[7] Presentation of Claudia Hill, EA, MBA, to the *President's Advisory Panel on Federal Tax Reform, March 3, 2005.*
[8] "Who Pays the Individual AMT?", OTA Paper 87, June 2000.
[9] Congressional Budget Office, *The Budget and Economic Outlook: Fiscal Years 2005 to 2014*, January 2004, Section 6.
[10] Leonard E. Burman, William G. Gale and Jeffrey Rohaly, "The AMT: Projections and Problems," *Tax Notes*, July 7, 2003.
[11] The estimates of direct individual tax impacts contained in this report were produced using a microsimulation model developed by the Manhattan Institute and Fiscal Economics, Inc. of Alexandria, Virginia. This model uses a large database of tax return data available from the Internal Revenue Service as well as information from the Congressional Budget Office, New York State Department of Taxation and Finance, and New York City to calculate all of the income and demographic variables needed to compute the federal income tax liabilities for statistically representative samples of the national, New York State, and New York City filing populations for each year out to 2014.
[12] National Taxpayer Advocate, *2004 Annual Report to Congress*, Vol. 1, p. iv, available at http://www.irs.gov/pub/irs-utl/ntafy2004annualreport.pdf.
[13] Congressional Budget Office, *The Budget and Economic Outlook: Fiscal Years 2005 to 2014*, January 2004, Section 6.

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