

Statement of

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The Individual Alternative Minimum Tax

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Chairman Neal, Ranking Member English, Members of the Subcommittee: Thank you for inviting me to share my views on the individual alternative minimum tax.

A precursor to the current individual alternative minimum tax (AMT) was originally enacted in 1969 to limit the amount of tax sheltering that taxpayers could pursue and to assure that high-income filers paid at least a minimal amount of tax.<sup>2</sup> The current AMT, however, has strayed far from those original goals. Under current law, the tax will affect more than 23 million taxpayers in 2007, mainly for reasons that have little or nothing to do with what most people would consider tax sheltering. The AMT is expected to generate more than \$800 billion in revenue over the next ten years under current law, a figure that rises to \$1.5 trillion if the 2001–2006 tax cuts are extended. In short, the AMT threatens to grow from a footnote in the tax code to a major component affecting tens of millions of taxpayers every year.

My testimony will outline how the AMT works, whom it affects, and why it demands attention. I will also discuss possible ways of reforming the AMT and why financing AMT reform or repeal is important. I finish with some concluding observations.

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<sup>1</sup> My testimony draws heavily on joint work with my Tax Policy Center colleagues, Jeff Rohaly, Greg Leiserson, and Bill Gale. Views expressed are my own.

<sup>2</sup> The original minimum tax was an addition to regular income tax. The current AMT is a floor on total tax liability. For details, see Joint Committee on Taxation (2007) or Burman, Gale, and Rohaly (2005).

## **How Does the AMT Work?**

The individual AMT operates parallel to the regular income tax with a different income definition, rate structure, and allowable deductions, exemptions, and credits. In short, after calculating regular tax liability, taxpayers must calculate their “tentative AMT” under the alternative rules and rates and pay whichever amount is larger. To calculate tentative AMT, taxpayers must first determine their alternative minimum taxable income (AMTI) and then subtract the applicable AMT exemption amount (which is subject to phase-out), calculate tax under the AMT rate schedule, and subtract any applicable credits. Technically, AMT liability is the excess, if any, of tentative AMT above the amount of taxes due under the regular income tax alone.

Alternative minimum taxable income is the sum of three components: regular taxable income for AMT purposes, AMT preferences, and AMT adjustments. Regular taxable income for AMT purposes is basically the same as taxable income used for regular tax purposes, except it is allowed to be negative if deductions exceed gross income.

An AMT preference is an item identified as a potential tax saving in the regular income tax that is not permitted in the AMT. An AMT adjustment is simply any other exclusion, exemption, deduction, credit, or other treatment (such as a method for computing depreciation) in the regular income tax that is either restricted or disallowed in the AMT. Because there is generally no interesting economic distinction between preferences and adjustments, I will refer to both as preferences.

Interesting distinctions emerge among the various preferences themselves, however. Preferences are of two types: exemptions or deferrals. Exemption preferences broaden the AMT tax base and include the disallowance of personal exemptions, the standard deduction, and itemized deductions for miscellaneous expenses and state and local taxes. Deferral provisions change the timing of the recognition of income and deductions, typically to accelerate income and postpone deductions. Thus, they tend to raise the current-year tax base—and hence revenues—but only at the expense of future tax bases and tax collections.

Middle-income AMT taxpayers are primarily affected by the exemption preferences, which are added to taxable income. The exemption measures might be interpreted as an effort to reduce tax incentives generally and move toward an alternative tax base that is broader than the regular income tax base.

Deferral preferences outnumber exemption preferences, but they are used much less frequently, tend to be used by high-income taxpayers, and generate much less revenue. Deferral items tend to be complex; taxpayers generally need to recalculate income and costs using different schedules and keep separate books for regular tax and AMT purposes. Also, taxpayers may use AMT liability created by deferral provisions—but not by exemption provisions—as a credit against future years’ regular tax liability in excess of the tentative AMT. The deferral provisions, coupled with the credit they create, are consistent with a policy goal of having every high-income filer pay some positive tax in each year, even if his or her overall multiyear tax liability does not change.

The Joint Committee on Taxation (2007) estimates that the three largest AMT preference items in 2006 were exemption preferences that few would consider to be aggressive tax shelters: deductions for state and local taxes (59 percent); personal exemptions, including exemptions for dependent children (22 percent); and miscellaneous itemized deductions for items such as unreimbursed business expenses (11 percent). The share of these preference items—already more than 90 percent—will rise further over the next several years as the AMT encroaches on more and more middle-income taxpayers.

After adding back their preference items and determining alternative minimum taxable income, taxpayers may then subtract an AMT exemption amount of \$45,000 for couples or \$33,750 for singles and heads of household. That exemption is limited, however, for taxpayers filing joint returns with AMTI over \$150,000 (\$112,500 for singles and heads of household).<sup>3</sup> AMTI less any applicable exemption is taxed at two rates—26 percent on the first \$175,000 and 28 percent on any excess above that amount. As under the regular income tax, capital gains and dividends are subject to lower tax rates. If the resulting “tentative AMT” is greater than tax before credits calculated under the regular income tax, the difference is payable as AMT.<sup>4</sup>

That comparison means that anything that reduces the regular income tax relative to the AMT or that increases the tentative AMT relative to the regular income tax will move taxpayers onto the AMT. For example, a reduction in regular income tax rates that is not matched by a comparable change in the AMT would make more taxpayers subject to the AMT. The converse is also true: increasing regular income taxes or cutting AMT taxes would move some taxpayers off the AMT. If the 2001 and 2003 tax cuts are allowed to sunset after 2010 as scheduled, for example, fewer taxpayers will owe AMT, albeit only because their regular tax bills will have increased.

The Congress has limited the AMT’s reach in recent years by temporarily increasing the AMT exemption and allowing the use of personal nonrefundable credits against the AMT.<sup>5</sup> For the 2006 tax year, for example, Congress raised the exemption from \$45,000 to \$62,550 for couples and from \$33,750 to \$42,500 for single filers and heads of household. Those changes kept 16.5 million taxpayers from falling into the AMT’s clutches. Because those adjustments were temporary, the Congress will need to pass additional legislation to prevent a sharp rise in the number of taxpayers subject to the AMT, from about 4 million in 2006 to more than 23 million in 2007.

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<sup>3</sup> The exemption is reduced by 25 percent of the amount that AMTI exceeds the relevant threshold. As a result, married couples filing joint returns can claim no exemption if their AMTI exceeds \$330,000; single filers and heads of household get no exemption if their AMTI is greater than \$247,500.

<sup>4</sup> To be precise, the foreign tax credit is calculated before calculating the AMT and incorporated into the comparison between regular tax liability and AMT liability. Most credits, however, are calculated after both regular tax and AMT liability and do not affect the taxpayer’s direct AMT liability.

<sup>5</sup> Other personal credits, such as the Earned Income Tax Credit, were allowed against the AMT by tax law changes included in the Economic Growth and Tax Relief Reconciliation Act of 2001 and will remain in place through 2010.

### Box 1. Calculating the AMT in 2007

A married couple with four children has an income of \$75,000 from salaries and interest on their savings account. Under the regular income tax, the family can deduct \$20,400 in personal exemptions for themselves and their children. They can also claim a \$10,700 standard deduction. For the regular tax, their taxable income of \$43,900 places them in the 15 percent tax bracket, and they owe \$5,803 in taxes before calculating the AMT or tax credits. Some, but not all, tax credits are allowed against both the AMT and the regular tax in 2007. Most importantly for this family, the child tax credit is allowed against both.

To calculate AMT liability, the couple adds their preference items—personal exemptions of \$20,400 and the standard deduction of \$10,700—to taxable income and subtracts the married-couple exemption of \$45,000, yielding \$30,000 in income subject to AMT. That amount is taxed at the first AMT rate of 26 percent, for a tentative AMT liability of \$7,800. The AMT equals the difference between the couple's tentative AMT and their regular income tax, or \$1,997.

Several points about this example are worth noting. First, the family is on the AMT because they have four children, not because they are rich or aggressive tax shelterers. Second, this tax situation is about as simple as it gets; the family has no deferral preferences, no itemized deductions, no capital gains, no AMT credits from previous years, and no other complicating factors. Third, the couple will receive no long-term benefit from regular tax rate reductions, because their income tax liability is set by the AMT, not the regular income tax. Finally, as long as the AMT is not indexed to inflation, the couple's future tax payments as a share of their income will rise, even if their real (inflation-adjusted) income does not change.

#### AMT Calculation Married couple filing jointly with four children, 2007

Calculate Regular Tax		Calculate Tentative AMT	
Gross income	\$75,000	Taxable income	\$43,900
<i>Subtract deductions</i>		<i>Add preference items</i>	
Personal exemptions (6 x \$3,400)	\$20,400	Personal exemptions	\$20,400
Standard deduction	\$10,700	Standard deduction	\$10,700
<b>Taxable income</b>	<b>\$43,900</b>	<b>AMTI</b>	<b>\$75,000</b>
<b>Tax before credits*</b>	<b>\$5,803</b>	<i>Subtract AMT exemption</i>	
(Tax bracket)	15%	AMT exemption	\$45,000
First \$15,650 taxed at 10%		<b>Taxable under AMT</b>	<b>\$30,000</b>
Next \$48,050 taxed at 15%		<b>Tax (tentative AMT)*</b>	<b>\$7,800</b>
		(AMT bracket)	26%
		First \$175,000 taxed at 26%	

$$\text{AMT} = \text{the excess of tentative AMT over regular income tax}$$
$$\text{AMT} = \$7,800 - \$5,803 = \$1,997$$

\* If the children are under age 17 the family could reduce its tax liability by \$4,000 because of the child tax credit. This credit is allowed against both the regular income tax and the AMT

Box 1 shows the calculation of AMT for a married couple having four children and earning \$75,000 in 2007. It illustrates how the AMT will ensnare even middle-class families with very straightforward tax returns if Congress does not act.

### **Who is Affected by the AMT?**

Under current law, about 4 million taxpayers were affected by the AMT in 2006.<sup>6</sup> With the expiration of the temporary AMT “patch” at the end of last year, the number of AMT taxpayers will increase dramatically in 2007 to 23 million, and continue to grow through 2010, eventually reaching 32 million, or more than one-third of all taxpayers. With the expiration of most of the 2001–2006 tax cuts in 2011, the number of AMT taxpayers will fall to 18.5 million, before again marching steadily upward to hit 39.1 million by 2017. If the 2001–2006 tax cuts are extended, 52.6 million taxpayers—almost half of all taxpayers—will pay the AMT by 2017.

Although most AMT taxpayers are moderately well off, the tax is steadily encroaching on families that most would consider solidly middle-class. By 2010, half of all tax filers making between \$75,000 and \$100,000 will pay the AMT, up from 36 percent this year and less than 1 percent in 2006, when the temporary AMT fix was still in place (table 1).<sup>7</sup>

Although the AMT may have originally been intended to prevent high-income individuals from sheltering all of their income and paying no tax, it now affects more tax filers in lower income classes than it does at the very top of the income scale. Since the 35 percent top rate of the regular income tax exceeds the 28 percent top statutory rate of the AMT, individuals with very high incomes who do not shelter a substantial portion of it will end up in the regular tax system. In 2006, only 31 percent of filers with incomes above \$1 million were affected by the AMT, compared to 51 percent of those with incomes between \$200,000 and \$500,000. By 2010, the difference is even starker: only 39 percent of millionaires will pay the AMT, but 94 percent of those in the \$200,000 to \$500,000 income class will.

What’s more, many tax shelters exploit the difference in tax rates between long-term capital gains, which face a maximum tax rate of 15 percent, and ordinary income, which can be taxed at rates as high as 35 percent under the regular income tax. However, the

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<sup>6</sup> Unless otherwise noted, estimates in this testimony are based on the Urban-Brookings Tax Policy Center’s microsimulation model of the federal tax system. Taxpayers affected by the AMT include those with direct AMT liability, those whose credits are limited by the AMT, and those who choose to take itemized deductions that are lower than their standard deduction in order to reduce or eliminate their AMT liability. Our estimates differ slightly from those reported by the Joint Committee on Taxation (2007) because of differences in underlying datasets, assumptions about growth of income over time and other factors, and definitions of what it means to be affected by the AMT. (I present our estimates rather than the JCT’s simply for purposes of internal consistency, since the JCT did not report all of the statistics I refer to in my testimony.) See Rohaly and Leiserson (2006) for further details on the Tax Policy Center’s methodology.

<sup>7</sup> Tax filers include all nondependent tax units filing an income tax return, regardless of whether they owe income tax. Taxpayers include all nondependent tax units with positive income tax liability after credits. The Joint Committee on Taxation (2007) reports estimates for “taxpayers,” which they define as all tax-filing units, including those that do not file tax returns and dependent returns.

**Table 1**  
**AMT Participation Rate (percent) by Individual Characteristics**

Group	Current Law				Current Law Extended <sup>a</sup>	Pre-EGTRRA Law	
	2006	2007	2010	2017	2017	2007	2010
<b>All Taxpayers<sup>b</sup></b>	4.0	25.9	33.6	34.7	48.6	10.6	16.0
<b>All Tax Filers</b>	2.8	18.4	24.5	27.8	37.4	8.0	12.4
<b>Tax Filers by Cash Income (thousands of 2006\$)<sup>c</sup></b>							
Less than 30	*	*	*	0.1	0.1	*	*
30-50	*	1.3	3.0	12.2	13.0	1.4	2.9
50-75	0.2	9.0	17.1	30.1	38.8	6.9	13.1
75-100	0.7	36.2	49.9	53.7	67.2	18.1	26.1
100-200	4.8	70.8	80.4	61.7	92.3	23.4	32.0
200-500	50.9	89.7	94.3	77.7	96.8	41.3	54.2
500-1,000	49.3	57.2	72.2	27.0	73.8	22.0	22.6
1,000 and more	31.4	33.8	38.8	20.3	40.1	20.3	19.1
<b>Tax Filers by Number of Children<sup>d</sup></b>							
0	1.9	11.4	16.8	15.9	28.5	2.4	3.9
1	2.7	24.8	32.4	40.9	48.4	7.1	16.0
2	5.0	34.5	42.0	54.8	56.6	22.2	34.0
3 or more	7.4	39.6	48.4	65.3	64.4	39.8	50.3
<b>Tax Filers By State Tax Level</b>							
High	4.6	21.8	27.7	31.6	40.7	10.9	16.2
Middle	2.3	18.5	25.0	28.3	37.9	7.7	12.0
Low	1.6	15.3	21.1	23.8	33.9	5.7	9.2
<b>Tax Filers by Filing Status</b>							
Single	0.9	2.4	3.8	4.7	10.5	1.1	1.7
Married Filing Joint	5.1	36.7	47.9	49.7	67.2	14.5	22.2
Head of Household	1.3	10.4	17.0	33.1	35.0	8.3	14.5
Married Filing Separate	5.7	34.5	47.4	48.7	62.9	12.8	17.6
<b>Married Couple, 2+ Kids, 75k&lt;Cash Income&lt;100k</b>	0.2	59.1	73.6	92.3	92.8	57.5	74.3
<b>Married Couple, 2+ Kids, 75k&lt;AGI&lt;100k</b>	0.8	78.2	88.6	97.7	97.8	68.8	86.4

Source: Urban-Brookings Tax Policy Center Microsimulation Model (version 1006-1).

Notes:

Includes returns with AMT liability on Form 6251, with lost credits, and with reduced deductions. Tax units who are dependents of other tax units are excluded from the analysis.

\* Less than 0.05 percent.

(a) Includes all 2010 sunset provisions in current law.

(b) Taxpayers are defined as returns with positive income tax liability net of refundable credits.

(c) Tax units with negative cash income are excluded from the lowest income class. For a description of cash income, see <http://www.taxpolicycenter.org/TaxModel/income.cfm>.

(d) Number of children is defined as number of exemptions taken for children living at home.

lower capital gains tax rate is not considered an AMT preference item, so high-income taxpayers who report a large amount of capital gains receive the same tax break under the AMT as under the regular income tax. In contrast, before 1987, the lower tax rate on capital gains was considered a preference item and was, in fact, the largest one.

In addition to being in certain income classes, taxpayers with any of several common situations are more likely than others to find themselves on the AMT:

*Large Families.* Personal exemptions are allowed against the regular income tax, but not the AMT. Taxpayers with large families have many personal exemptions, which significantly reduce their regular income tax liability relative to tentative AMT. In 2006, taxpayers with three or more children were almost four times as likely to owe AMT as those with no children (table 1). By 2010, almost half of families with three or more children will find themselves on the AMT, compared to only 17 percent of those without children.

*High State and Local Taxes.* State and local taxes are deductible under the regular income tax, but not the AMT. Thus, high state and local taxes reduce regular tax liability relative to AMT, increasing the likelihood that a taxpayer will owe AMT. This helps explain why, in 2004, taxpayers in the New York area, the District of Columbia, and California were most likely to owe AMT (Burman and Rosenberg 2006). They not only faced higher-than-average state and local tax burdens, but they also had higher than average incomes, making them substantially more likely than the average taxpayer to be subject to AMT. In 2006, households in high-tax states were almost three times more likely to be on the AMT than those in low-tax jurisdictions (table 1). With the dramatic growth of the AMT over the rest of this decade, however, this differential is slated to fall dramatically. By 2010, residents of high-tax states will only be about 30 percent more likely to fall prey to the AMT than those in low-tax states (28 percent of households in high-tax states will face the AMT compared to 21 percent in low-tax states.)

*Marriage.* Most married couples pay less tax under the regular income tax than they would if they were single. (That is, most “marriage penalties” have been eliminated and many couples receive “marriage bonuses.”) This is not true under the AMT. AMT tax rate thresholds are identical for married and single taxpayers and the AMT exemption is only 33 percent larger for couples than for singles (except for those for whom the exemption has been phased out). In contrast, the standard deduction for couples under the regular income tax is twice that for singles. The combination of the AMT marriage penalties, the fact that married couples often have children, and the fact that married couples tend to have higher household incomes resulted in married couples being more than five times as likely to owe AMT as singles in 2006. In 2007, with expiration of the temporary AMT fix, married couples are 15 times more likely to owe AMT than singles (table 1).

Taxpayer characteristics can combine to create very high probabilities of falling prey to the AMT. For example, absent a change in law, the AMT will become the de facto tax system for upper-middle-class families with children. In 2006, less than 1 percent of married couples with two or more children and adjusted gross income between \$75,000 and \$100,000 were affected by the AMT, but by 2010 that share will rise to 89 percent (table 1).

Other common situations that make a taxpayer more likely to incur the AMT include having high medical expenses or simply taking the standard deduction. Taxpayers may deduct medical expenses in excess of 7.5 percent of AGI under the regular income tax, but the threshold is 10 percent of AGI under the AMT. Thus, taxpayers with both high

incomes and high medical expenses can be hit hard by the AMT. Even claiming the standard deduction can force an individual into AMT territory. Although most AMT taxpayers itemize deductions, the standard deduction under the AMT is worthless for the few who claim it: it reduces regular tax liability without affecting tentative AMT.

Finally, current AMT rules allow for the possibility of some very perverse outcomes. Under the regular tax, filers may deduct legal fees incurred in cases that generate taxable damages (such as punitive damages or damages for nonphysical injuries) as miscellaneous itemized deductions to the extent that they exceed 2 percent of adjusted gross income. However, the AMT disallows miscellaneous deductions. As a result, a taxpayer with substantial legal fees will have much less taxable income under the regular tax than under the AMT. If the legal fees are high relative to the damage award, the taxpayer can actually owe more AMT than her net gain from a lawsuit (Johnston 2003).

The exercise of incentive stock options generally creates income that is immediately taxable under the AMT, but that is not taxable under the regular income tax until the stock is actually sold. Individuals must include in AMTI the excess of the fair market value of the stock over the purchase price of the stock at the date of exercise (JCT 2006). This can cause taxpayers with very modest cash incomes to owe substantial AMT. If the stock is ultimately sold at a profit, the AMT paid earlier can be taken as a credit against the regular income tax owed. But if the stock price falls, the taxpayer can end up with a substantial AMT liability even though no income is ever realized.<sup>8</sup>

### **Why is the AMT Becoming a “Mass Tax”?**

Although the factors described above help explain why individual taxpayers are affected by the AMT, they do not explain the dramatic growth in the AMT. Two factors reduce regular income tax liabilities relative to tentative AMT over time and largely explain the explosive growth in AMT projected through 2010 and beyond.

*Inflation.* The AMT is not adjusted for inflation whereas the regular income tax is. This means that if an individual’s income just keeps pace with inflation each year, his or her regular income tax would remain constant (in real terms) while AMT liability would rise. The Joint Committee on Taxation (2007) estimates that the number of AMT taxpayers in 2010 would be reduced by about 88 percent (26 million) if the exemption had been indexed for inflation since 1987.<sup>9</sup>

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<sup>8</sup> The Tax Relief and Health Care Act of 2006 allows certain taxpayers to claim a refundable credit for 20 percent of their unused long-term alternative minimum tax (AMT) credits (up to \$5,000) per year. The refundable credit phases out for high-income taxpayers; the phase-out is based on the personal exemption phase-out. The refundable AMT credits can generally only be claimed for tax years 2007–2012 (JCT 2006 and personal communication from Jerry Tempalski).

<sup>9</sup> Real income growth also causes more taxpayers to become subject to the AMT over time because *effective* AMT tax rates are much higher than regular income tax rates for most taxpayers. (See Burman, Gale, and Rohaly 2005 for a discussion.) Thus, in most cases, the more income that is subject to AMT, the more likely it is that tentative AMT will exceed regular income tax. This is especially a problem for taxpayers in the phase-out range for the AMT exemption who are effectively taxed at rates 25 percent higher than the statutory AMT rate. The 26 percent rate becomes 32.5 percent; the 28 percent rate becomes 35 percent. This explains why almost all taxpayers with incomes between \$200,000 and \$500,000 are affected by the AMT (table 1). Real income growth is a minor factor in projected AMT growth compared

*The 2001–2006 Tax Cuts.* The tax cuts reduced regular income tax liability, but made only temporary changes to the AMT. As a result, regular income tax declined relative to AMT liability, dramatically increasing the number of taxpayers subject to the AMT. In 2007, about 23 million taxpayers will be subject to the AMT under current law, more than double the 10.2 million that would have been affected had the tax cuts not been enacted.

### **Should We Care About the Dramatic Growth of the AMT?**

While many people decry the expanding reach of the AMT, others assert that there is no cause for concern. Some argue that the complexity taxpayers face in calculating their taxes twice is not a reason to do away with the AMT, but rather cause to eliminate the regular tax. Others assert that the growing prevalence of tax preparation software negates any problems of complexity. In fact, both of those arguments have significant flaws.

Some people, observing the complexity of having two parallel methods of calculating taxes, argue that the best solution is to repeal the regular income tax. This option would have several advantages according to its proponents. They claim that the AMT is nearly a flat-rate tax with only two statutory rates, 26 and 28 percent, both of which are significantly lower than the top statutory rate of 35 percent under the regular income tax. In addition, the AMT applies those lower rates to a broader income base, since it eliminates various special tax breaks that exist in the regular tax system. Since the AMT applies lower marginal rates to a broader tax base, it is a more efficient way of raising revenue than the regular tax system.

This analysis is incorrect for several reasons.<sup>10</sup> First, the AMT actually imposes four marginal tax rates, not two. The phase-out of the AMT exemption creates higher phantom tax rates of 32.5 and 35 percent, the latter equal to the top rate under the regular income tax.<sup>11</sup> And in fact, significantly more taxpayers face higher effective marginal tax rates under the AMT than they would under the regular income tax. In 2006, 71 percent of AMT taxpayers faced a higher marginal rate under the AMT; that figure will rise to 89 percent by 2010 as the AMT ensnares more and more middle-income filers who would have faced statutory rates of 15 or 25 percent under the regular income tax (Leiserson and Rohaly 2006).

Second, as described above, some of the base broadeners in the AMT have questionable validity as policy. In addition, the relatively high AMT exemption actually means that the

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to the lack of indexation and the impact of the tax cuts, however. Only 777,000 taxpayers would be subject to the AMT in 2011 if the AMT were indexed back to 1987 levels, according to the Joint Committee on Taxation. If the tax cuts are extended, about five times as many people would be affected, even with indexation.

<sup>10</sup> For more detailed discussion, see Burman and Weiner (2005).

<sup>11</sup> Although the AMT generally preserves the lower statutory tax rates on capital gains and qualified dividends that exist under the regular tax system, the effect is diminished by the phase-out of the AMT exemption. Rather than the advertised 15 percent rate, taxpayers with incomes in the phase-out range can face effective marginal tax rates as high as 22 percent on gains and dividends. See Leiserson (forthcoming) for details.

AMT tax base is often smaller than the regular income tax base because the AMT exemption is larger than the total of all preference items for most taxpayers. In 2006, 63 percent of AMT taxpayers had more income subject to tax under the regular tax than they did under the AMT. That number will rise to 87 percent by 2010 (Leiserson and Rohaly 2006).

Thus the conventional wisdom that the AMT applies a lower marginal tax rate to a broader income base and is therefore more efficient than the regular tax system is incorrect. In fact, exactly the opposite is true. Most AMT taxpayers face a higher marginal rate applied to a more narrow tax base than they would if they were in the regular tax system.

Other people assert that the complexity of calculating taxes under both the regular tax and the AMT does not pose a real problem. Relatively few taxpayers actually prepare their own tax returns, they argue, and instead rely on tax preparation software, which calculates the AMT automatically, or paid tax preparers. It is true that the AMT is less complex for filers who use tax preparation software or a paid preparer, but at the cost of the income tax system's transparency. The fact that the tax system is a black box for so many people is something to regret, not champion.

In order to make informed decisions about work, saving, retirement, education, and other important matters, people should understand how the tax system affects those choices, but the AMT leads to endless confusion. Taxpayers will have a hard time predicting their marginal tax rate if they do not know whether they will be on the AMT. What's more, many people may be confused about what constitutes an AMT preference item. For example, *Consumer Reports* magazine reported in the February 2007 issue that the AMT is "snagging middle-income taxpayers with big families, people who pay lots of state tax, and those with high mortgage interest." Mortgage interest, of course, is not an AMT preference item (except on home equity lines and second mortgages used to pay for nonhousing expenses). And needless complexity contributes to public perceptions that the income tax system is unfair.

In any case, computer software has its limitations. For example, individuals who were on the AMT in the previous year must figure out the state tax deduction that would have been allowed on their prior-year tax return before they were subject to the AMT. This is necessary in order to figure out how much of their state tax refund in the current year is taxable. This calculation is so complex that my tax software doesn't do it. It recommends that I go back to my prior-year return, and keep refiguring my state tax deduction over and over until the AMT gets down to zero. This is complex even with software. Without it, the computation would be mind-numbing.

A second example involves the choice between itemizing and taking the standard deduction. Under the regular income tax, taxpayers claim the standard deduction as long as it exceeds the amount of itemized deductions. But taxpayers on the AMT should itemize even if their standard deduction is greater, as long as their itemized deductions exceed the portion of the standard deduction that makes their regular tax less than the

AMT. Even though the AMT disallows the standard deduction, some taxpayers who do not owe much AMT (i.e., whose tentative AMT is not that much more than their tax under the regular system) get a partial benefit from the standard deduction. That is, they would not be on the AMT if they did not take the standard deduction. Does that sound complicated? It is. The last time I checked, my tax software did not deal with that issue either. Taxpayers should not have to figure this out for themselves.

Is there anything positive to say about the AMT? Over the long run, the AMT in its current form will become a more effective revenue generator than the regular income tax. The AMT will raise federal revenues by more than \$800 billion over the next ten years under current law and by \$1.5 trillion if the 2001–2006 tax cuts are extended. Indeed, our estimates show that in 2007, it would cost less to eliminate the regular income tax than to eliminate the AMT. Over a longer time horizon, the Congressional Budget Office (2003) estimates that, primarily because of the AMT, federal taxes will claim 25 percent of GDP by 2050, compared with just 17 percent today. That huge influx of revenue could help fund growing entitlement programs such as Social Security and Medicare as the baby boom generation retires.

But the AMT's power as a revenue generator stems entirely from the fact that its parameters are not indexed for inflation. In consequence, people whose incomes only just keep pace with inflation will face higher and higher average tax rates over time (a phenomenon sometimes referred to as bracket creep). And more and more people will find themselves in this situation as they become subject to the AMT over time. That is clearly not a sustainable path.

Given this and all the other design flaws inherent in the AMT—marriage and family penalties, higher marginal tax rates that are likely to discourage working and saving and encourage inefficient tax avoidance behavior, and needless complexity—reforming or repealing the AMT in conjunction with reforming the regular income tax is far preferable to making the AMT the basis of our tax system.

### **Financing AMT Reform or Repeal**

Reforming or repealing the AMT is costly and financing that cost is important. Outright repeal of the AMT, without any other offsetting changes, would reduce tax revenues by more than \$800 billion through fiscal year 2017, *assuming that the 2001–2006 tax cuts expire after 2010*. If the tax cuts are extended, the 11-year revenue loss nearly doubles to almost \$1.6 trillion.

Some have argued that since everyone is aware that this AMT revenue should never have been collected in the first place, it is not necessary to offset the cost of repeal. The real baseline, they assert, should assume no AMT. That is a misleading argument. In fact, the AMT masked the true cost of the 2001 tax act. Congressional leaders understood that the AMT would “take back” a significant portion of the tax cuts and therefore keep their estimated cost down to the tax bill's advertised \$1.35 trillion. By 2010, the AMT will reclaim almost 28 percent of the individual income tax cuts, including more than 70

percent of the cut that would have gone to taxpayers making between \$200,000 and \$500,000 (Leiserson and Rohaly 2006).

Repeal of the AMT would be not only prohibitively expensive but also extremely regressive. Nearly 96 percent of the tax cut in 2007 would go to the top fifth of income earners and 80 percent would go to the top tenth. More than half would go to taxpayers with incomes greater than \$200,000.<sup>12</sup> After-tax incomes of taxpayers with incomes between \$200,000 and \$500,000 would rise by 2.7 percent, or an average of nearly \$6,000. In contrast, taxpayers in the middle quintile of the income distribution would receive less than 1 percent of the benefits and would see their after-tax income rise by an average of only \$5.

#### *Reforming the AMT to Spare the Middle Class*

Rather than outright repeal, the AMT could be reformed in order to shield middle- and upper-middle-income taxpayers from its effects.<sup>13</sup> The simplest reform would be to extend the exemption increase in place for 2006 and index the AMT for inflation. This would prevent inflation from increasing tentative AMT (in real terms) and conform the AMT treatment with that under the regular income tax.<sup>14</sup> If indexation were applied to rate brackets and the phase-out as well as the exemption, only 3.6 million taxpayers would be subject to the AMT in 2007, down from 23.4 million under current law (table 2). The number of AMT taxpayers with incomes less than \$100,000 would fall by more than 98 percent. By 2010, real income growth would increase the number of AMT taxpayers to 4.6 million, still significantly lower than the projected 32.4 million under current law.

A more comprehensive reform would also allow dependent exemptions, state and local tax deductions, the deductions for miscellaneous expenses and medical expenses, and the standard deduction for AMT purposes. This would reduce the number of AMT taxpayers to fewer than 500,000 in 2007 and would spare virtually all taxpayers with incomes below \$200,000 from the AMT.

These reforms would, however, substantially reduce federal tax revenues. We estimate that indexing the AMT for inflation from 2006 levels would reduce revenues by about \$0.5 trillion over the ten-year period from 2007–2016 assuming the 2001–2006 tax cuts expire as scheduled. If the tax cuts are extended, the cost rises to \$0.9 trillion. The comprehensive reform package would reduce revenues by \$0.7 trillion if the tax cuts expire and \$1.2 trillion if they are extended.

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<sup>12</sup> The JCT estimates that slightly less than half of the AMT is paid by taxpayers with adjusted gross income (AGI) over \$200,000 in 2007. The smaller share arises because AGI is often lower than the cash income measure used by the Tax Policy Center. Cash income, which is similar to the income measure used by the Department of the Treasury in its distributional analysis, includes items such as contributions to IRAs and 401(k) plans and tax-exempt bond interest that are excluded from AGI.

<sup>13</sup> For more information on these options, and others, see Burman et al. (2007).

<sup>14</sup> The AMT exemption was increased between 2005 and 2006 as an ad hoc inflation adjustment, but it has never been formally indexed for inflation. The allowance of personal non-refundable credits against both the regular tax and the AMT would also be extended under all reform options considered here.

**Table 2. Effect of AMT Reform Options on Number of AMT Taxpayers (millions) by Cash Income Class, 2007<sup>1</sup>**

Reform Option	Cash Income Class (\$ thousands)				
	All	0-100	100-200	200-1,000	More than 1,000
<b>Extend and index 2006 law</b>	3.6	0.1	0.7	2.6	0.1
With financing					
Increase top three regular tax rates by 12% <sup>4</sup>	2.4	0.1	0.7	1.5	0.1
Increase AMT rates by 20%	9.3	0.4	4.0	4.5	0.3
Disallow preferential rates on capital gains and qualifying dividends in the AMT, increase top three regular tax rates by 2%	4.5	0.2	1.3	2.9	0.2
<b>Broad reform: extend and index 2006 law; allow dependent exemptions; allow standard and itemized deductions<sup>4</sup></b>	0.4	0.0	0.1	0.3	0.1
With financing					
Increase top three regular tax rates by 14%	0.3	0.0	0.1	0.2	0.0
Increase AMT rates by 38%	6.2	0.1	1.6	4.2	0.4
Disallow preferential rates on capital gains and qualifying dividends in the AMT, increase top three regular tax rates by 7%	1.2	0.0	0.3	0.8	0.1
<b>Addendum: Current law baseline</b>	23.4	7.0	11.8	4.4	0.1

Source: Urban-Brookings Tax Policy Center Microsimulation Model (version 1006-1).

(1) Calendar years. Baseline is current law. Plans take effect 1/1/07. Excludes dependent returns.

(2) AMT taxpayers are defined as those with an AMT liability from form 6251, with lost credits, or with reduced deductions.

(3) Unless otherwise noted, increases in tax rates are applied to rates before and after the sunset of the 2001-2006 tax cuts separately.

(4) Includes state and local tax, miscellaneous, and medical deductions.

Both options would also be regressive. Indexing the AMT for inflation would provide a tax cut of 1.4 percent of after-tax income to those in the top quintile in 2010 (table 3). It would provide an increase of less than one-tenth of one percent to those in the middle fifth of the income distribution. The broad reform package would increase the after-tax incomes of those in the top quintile by 1.9 percent in 2010 while those in the top ten percent would see an increase of 2.1 percent. Again, those in the middle of the income spectrum would receive virtually nothing.

#### *Offsetting the Revenue Cost of the Middle-Class Reforms*

The revenue cost of the reforms outlined above could be offset in a variety of ways. All the offset options described below are intended to be roughly revenue neutral over the 2007–2016 budget window, and assume that the 2001–2006 tax cuts expire as scheduled.<sup>15</sup> If the tax cuts are extended, each of the options would generally lose substantial amounts of revenue over the budget window, and many more people would be subject to the AMT after 2010.

Although there are myriad ways in which the revenue cost of the reforms could be financed, I will discuss three illustrative options: (a) increasing the top three income tax rates under the regular tax; (b) increasing the AMT rates; or (c) combining (a) with disallowing the preferential rates on capital gains and dividends under the AMT.

Financing the reforms by increasing AMT rates rather than by raising regular income tax rates leaves more individuals subject to the AMT, particularly those with incomes over \$200,000. Since both of the reforms mentioned above involve substantial increases in the AMT exemption, they tend to shield those with incomes under \$100,000 from the AMT. In addition, raising regular income tax rates and thus regular income tax liability reduces the number of people for whom tentative AMT is greater than regular tax and thus further reduces the number of AMT taxpayers. In contrast, raising AMT rates tends to increase the number of people for whom tentative AMT is greater than regular tax.

Eliminating the preferential rates for capital gains and dividends under the AMT allows smaller increases in either regular or AMT tax rates. These options also tend to retarget the AMT toward those with very high incomes—since those taxpayers tend to have a higher share of their income in the form of capital gains—which is more consistent with the AMT’s original intent. Moreover, since many tax shelters exploit the lower tax rate on capital gains, eliminating preferential gains rates would likely do more to stem tax sheltering than any of the existing AMT preferences.<sup>16</sup>

Extending the exemption and indexing the AMT for inflation would require a 12 percent increase in the top three regular income tax rates. (We raise only the top rates because it is primarily taxpayers in the upper brackets who are affected by the AMT.) Under this option, the top rate would increase from 35 to 39.1 percent through 2010 and from 39.6

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<sup>15</sup> Tax Policy Center estimates are *not* revenue estimates because they do not account for the behavioral responses that would be considered by the JCT. JCT estimates, however, are not available for these options.

<sup>16</sup> See Burman (1997) for a discussion of the connection between capital gains tax preferences and tax shelters.

Table 3. Distributional Impact of AMT Reform Options, 2007 and 2010<sup>1</sup>

Reform Option	Percent Change in After-Tax Income <sup>3</sup>							
	2007				2010			
	Middle Quintile	Fourth Quintile	Top Quintile	Top 1%	Middle Quintile	Fourth Quintile	Top Quintile	Top 1%
<b>Extend and index 2006 law</b>	0.0	0.2	1.0	0.1	0.0	0.4	1.4	0.1
With financing								
Increase top three regular tax rates by 12% <sup>4</sup>	0.0	0.2	0.1	-2.1	0.0	0.4	0.6	-1.9
Increase AMT rates by 20%	0.0	0.2	-0.6	-2.2	0.0	0.4	-0.4	-2.6
Disallow pref. rates on capital gains and qualifying dividends, increase top three regular tax rates by 2%	0.0	0.2	-0.5	-4.0	0.0	0.4	0.1	-3.6
<b>Broad reform: extend and index 2006 law; allow dependent exemptions; allow standard and itemized deductions<sup>5</sup></b>	0.0	0.2	1.3	0.7	0.0	0.4	1.9	1.0
With financing								
Increase top three regular tax rates by 14%	0.0	0.2	0.2	-2.1	0.0	0.4	0.8	-1.8
Increase AMT rates by 38%	0.0	0.2	-0.7	-3.4	0.0	0.4	-0.5	-3.8
Disallow preferential rates on capital gains and qualifying dividends, increase top three regular tax rates by 7%	0.0	0.2	-0.3	-4.0	0.0	0.4	0.4	-3.3
<b>Repeal the AMT</b>	0.0	0.2	1.5	1.1	0.0	0.4	2.1	1.4
With financing								
Repeal, increase top three regular tax rates by 15%	0.0	0.2	0.2	-2.1	0.0	0.4	0.8	-1.7
Repeal, repeal state and local tax deduction, reduce regular tax rates by 2%	0.0	-0.1	0.2	-0.5	0.0	0.2	0.9	-0.2
Repeal, roll back rates on capital gains and qualifying dividends, roll back top three regular tax rates and increase by 8 percent above pre-EGTRRA levels	0.0	0.1	-1.0	-5.2	0.0	0.3	-0.4	-4.6

Source: Urban-Brookings Tax Policy Center Microsimulation Model (version 1006-1).

(1) Calendar years. Baseline is current law. Plans take effect 1/1/07. Includes both filing and non-filing units but excludes those that are dependents of other tax units.

(2) AMT taxpayers are defined as those with an AMT liability from form 6251, with lost credits, or with reduced deductions.

(3) After-tax income is cash income less: individual income tax net of refundable credits; corporate income tax; payroll taxes; and estate tax. For a description of cash income see <http://www.taxpolicycenter.org/TaxModel/income.cfm>

(4) Unless otherwise noted, increases in tax rates are applied to rates before and after the sunset of the 2001-2006 tax cuts separately.

(5) Includes state and local tax, miscellaneous, and medical deductions.

to 44.3 percent for 2011 and thereafter. The number of AMT taxpayers would fall to 2.4 million in 2007; only 100,000 of them would have incomes below \$100,000. The change in tax burdens by income quintiles would be small, never more than one percent of income. The highest-income taxpayers, however, would pay more tax. By 2011, the top one percent pays additional tax equal to about three percent of income.

If AMT rates were raised instead, to 31.1 and 33.5 percent, 9.7 million taxpayers would be affected by the AMT in 2007; the number of AMT taxpayers with incomes of \$200,000 and over would actually rise relative to current law. AMT liabilities would also increase for higher-income households and so they would pay higher taxes on average. Households in the top ten percent would experience a tax increase of about 1 percent of income through 2010, and those in the top one percent would pay additional taxes equal to more than 2 percent of income. After 2010, the tax increases are much smaller because the higher AMT exemption in combination with the pre-EGTRRA regular income tax rates results in fewer upper-income households owing AMT.

If the preferential rates on capital gains and dividends were disallowed for AMT purposes, the required increase in the top three regular income tax rates would be only 2 percent. The top rate, for example, would need to rise from 35 to 35.8 percent through 2010 and from 39.6 percent to 40.4 percent thereafter. This option would reduce the number of AMT taxpayers by about 80 percent in 2007, to 4.5 million. The AMT would be much more targeted at those with high incomes; taxpayers with incomes greater than \$1 million would actually be more likely to owe AMT under this option than under current law. This option has very small effects on average tax burdens by quintiles—in all cases, tax changes are less than 1 percent of income. The tax change is much more significant for those at the very top, however. The top one percent would see an average tax increase of about 4 percent of after-tax income in 2007, although the size of that tax increase would decline over time.

Since broad reform of the AMT costs substantially more, financing it would require larger increases in either regular or AMT rates. The required increase in the top three regular rates would be 14 percent, resulting in a top rate of 39.9 percent through 2010 and 45.2 percent thereafter. This option reduces the number of AMT taxpayers to only 300,000 in 2007, including only 100,000 with incomes less than \$200,000. Since this option reduces tax revenues in the first five years and increases it thereafter, the largest tax increases occur after 2010. The average tax increase is about 3 percent of income for those in the top one percent after 2010.

Financing the broad reform package would require a 38 percent increase in AMT rates, to 36 and 38.7 percent. As a result, 6.2 million taxpayers would face the AMT in 2007. Although only 100,000 taxpayers with incomes under \$100,000 would be on the AMT, there is little reduction compared to current law for those making between \$200,000 and \$1 million. And virtually all taxpayers with incomes greater than \$1 million would be on the AMT.

Finally, broad reform could be financed by disallowing the preferential rates on capital gains and dividends under the AMT combined with an increase in the top three regular income tax rates. The required rate increase would be 7 percent resulting in a top rate of 37.4 percent through 2010 and 42.3 percent thereafter. This option would reduce the number of AMT taxpayers by about 95 percent in 2007, to just 1.2 million, with only 300,000 of them having incomes less than \$200,000. This option would have very small effects on the distribution of tax burdens by quintile. But disallowing the lower capital gains rates under the AMT, combined with the regular tax rate increases, results in significant tax increases for those at the very top of the income scale – over 3 percent of income for those in the top one percent before 2010.

#### *Offsetting the Revenue Cost of Repeal*

Full repeal of the AMT could also be financed in a variety of ways. Obvious candidates include: (a) increasing regular income tax rates; (b) repealing the state and local tax deduction; and (c) repealing the reduced tax rates for capital gains and dividends.

The required increase in the top three rates required to offset the revenue loss from repeal would be 15 percent, resulting in top rates of 32.3, 38.1, and 40.4 percent through 2010 (from 28, 33, and 35 percent) and 35.8, 41.5, and 45.7 percent in 2011 and thereafter (from 31, 36, and 39.6 percent).<sup>17</sup> This options cuts taxes in the first five years and increases them in the second five years, after the 2001-2006 tax cuts expire. Most of the net tax increases are experienced by taxpayers in the top five percent of the income distribution. The top one percent face the largest tax increases, averaging over 3 percent of income after 2010. This occurs because very high income earners are most affected by the rate increases and do not tend to benefit as much from repeal of the AMT since they tend not to be on the AMT in the first place.

Another option to finance AMT repeal would be to broaden the tax base significantly by repealing the deduction for state and local taxes, as recommended by President Bush's tax reform advisory panel. The deduction is not allowed for AMT purposes. And since most taxpayers in the bottom 60 percent of the income distribution take the standard deduction, the primary beneficiaries of the deduction are those at the very top of the income scale who escape the AMT. More than 70 percent of those in the top 1 percent of the income distribution will benefit from the deduction in 2007, with an average tax savings of almost \$12,000 or 1.3 percent of income. Repealing the state and local tax deduction raises more than enough revenue to pay for repeal of the AMT, although it would not if the 2001-2006 tax cuts are extended. This allows for income tax rates to be *reduced* across-the-board by 2 percent.<sup>18</sup>

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<sup>17</sup> It would also be possible to raise rates in 2007 and keep them at that level permanently, rather than increasing them again in 2011 when the tax cuts expire. In that case, the revenue-neutral rates would be 34.8, 41, and 43.5 percent. This option is roughly revenue neutral over both the first and second five-year periods of the budget window.

<sup>18</sup> Alternatively, the bottom rates could remain the same and the top three rates could be reduced by 5 percent, resulting in a top statutory rate of 33.1 percent through 2010 and 37.5 percent thereafter. By 2011, this option is effectively distributionally neutral.

The option has very small effects on overall tax burdens by income group—amounting to less than 1 percent of income in any year. Middle-income taxpayers receive a very small benefit from the tax rate reduction and are not much affected by the elimination of the deduction since few taxpayers itemize in that income range. Itemizers in the fourth quintile lose more than they gain in 2007, because most itemize, but many have not become affected by the AMT in that year. By 2010, that group overall experiences a modest tax cut. Within the top quintile, elimination of the AMT is more significant than the loss of the state and local tax deduction until 2010. After that, this income group loses more than they gain, but the net losses are never large, even within the top 1 percent. Overall, this option makes the tax system modestly more progressive.<sup>19</sup>

Finally, AMT reform could be financed by rolling back the 2003 reductions in the tax rates on capital gains and qualified dividends combined with an 8 percent increase in the top three income tax rates above their pre-2001 levels, resulting in a top rate of 42.8 percent. This option would cut taxes by a modest amount for middle- and upper-middle-income taxpayers. It would increase taxes significantly for high-income taxpayers, especially before 2011 when current law allows for substantial reductions in the rates on capital gains and dividends. Taxpayers in the top one percent of the income distribution would, on average, pay additional taxes equal to more than 5 percent of after-tax income in 2007. These households lose out for three reasons—they are most affected by the income tax rate increases, they have a large amount of capital gains and dividends, and many taxpayers in this group do not owe AMT (and thus receive no benefit from repeal).

This option would increase revenues by about \$100 billion in the first five years of the budget period and reduce revenues by the same amount in the second five. Beyond the budget period, it would lose increasing amounts of revenue.

## Conclusions

Lack of inflation indexing in the alternative minimum tax expands the reach of the tax each year. The 2001–2006 tax cuts have further exacerbated the problem by reducing regular income tax liabilities without corresponding permanent changes to the AMT. Caught amid these trends, one in three American taxpayers will soon face a tax that almost none of them were ever meant to pay. Although the goals of the AMT—ensuring high-income taxpayers pay at least some amount of tax each year, and reducing inefficient tax sheltering—may command public support, the AMT is a highly imperfect way of achieving those goals. In particular, under current law, the AMT will come to plague the middle- and upper-middle-income classes with undue complexity, a narrower tax base, and higher marginal tax rates than under the regular income tax.

As the AMT expands, the political benefits of achieving a solution increase as well. A number of sensible reform options are available. A significant barrier to AMT reform is the challenge of what to do about the lost revenues. Official budget estimates assume that

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<sup>19</sup> A number of other issues arise in considering whether to finance AMT repeal by eliminating the state and local tax deduction. See Rueben (2006) for a general discussion, or Burman and Gale (2005) in the context of the tax reform panel's proposal.

the AMT will provide tax revenues of nearly one trillion dollars over the next ten years. Even modest reforms, such as extending the AMT “patch” and indexing the AMT for inflation, would reduce tax revenues over that period by more than half a trillion dollars. Given our fiscal situation, making up that lost revenue would seem to be a necessary precondition for reform.

I have illustrated a number of options for reforming or repealing the AMT without increasing the deficit over the ten-year budget period. The options show that it would be feasible to repeal or sharply scale back the AMT in a fiscally responsible manner with relatively minor dislocations. All of them produce winners and losers—it would be impossible to design a sensible revenue-neutral alternative to the AMT that didn’t—but many would cut taxes modestly on the middle class and have relatively small effects on those with higher incomes.

There are untold numbers of other fiscally responsible options available, and some of them might be preferable to the ones displayed here. For example, Ways and Means Committee Chairman Rangel has proposed to improve tax compliance and collections as a way to raise revenue. To the extent that more of the tax that is due to the IRS could be collected, the revenue needs to finance AMT reform would be reduced. As a result, the options here could be implemented with smaller income tax rate increases or without the use of other offsets such as elimination of the deduction for state and local taxes.

The ideal solution would be to address the AMT in the context of a complete overhaul of the income tax, such as the proposal made by the President’s Advisory Panel on Federal Income Tax Reform. Although the AMT is probably the best example of pointless complexity in the tax system, it is far from the only one. Addressing all of the sources of complexity, unfairness, and inefficiency in the tax system at the same time would strengthen the income tax—the major source of federal tax revenues—at a time when unprecedented demands are about to be placed on the federal government because of the impending retirement of the baby boomers.

That said, the perfect should not be the enemy of the good. Many of the incremental options I have outlined here would significantly improve our tax system. I applaud the subcommittee for taking the first steps toward advancing this goal.

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