

AMERICAN BAR ASSOCIATION

SECTION OF TAXATION

REPORT TO THE HOUSE OF DELEGATES

RECOMMENDATION

1 RESOLVED, That the American Bar Association recommends that Congress reduce the
2 federal tax burdens and compliance costs attributable to the Alternative Minimum Tax (AMT)
3 on individuals by repealing the individual AMT.

4 FURTHER RESOLVED, That the American Bar Association recommends to Congress that if
5 repeal of the individual AMT is not feasible then the individual AMT should be modified in a
6 manner consistent with its original purpose to ensure that the AMT applies only to designated
7 high-income individuals.

REPORT

Introduction

More than 150 taxpayers with 1966 adjusted gross incomes of \$200,000 avoided paying any federal income tax; many other high-income taxpayers paid relatively little tax. Responding to that information, Congress enacted the Alternative Minimum Tax (“AMT”) in 1969.¹

The initial AMT targeted relatively few tax-avoidance techniques: excess investment interest expense; accelerated depreciation of personal property subject to a net lease and of real property; amortization of pollution control facilities and of railroad rolling stock; gains on the exercise of certain stock options; bad debt reserves of financial institutions; one-half of a taxpayer’s net long-term capital gain; and depletion that exceeded the property’s basis.² Several of those preferences were irrelevant to middle-income taxpayers. Total preferences were offset by a \$30,000 exemption and by the regular income tax; the AMT applied at a flat rate of 10 percent to the balance.

After numerous revisions, the AMT now requires a totally separate tax computation.³ It is assessed at graduated rates of 26 percent and 28 percent and applies to more than 25 adjustment and preference items. Its exemption varies based on marital status and phases out based on income. Unlike the personal exemption and standard deduction used in computing regular income tax liability, the AMT exemption is not automatically adjusted for inflation. Because its exemption applies to the recomputed alternative minimum taxable income, a taxpayer may owe AMT even if the exemption exceeds total preferences and adjustments.

Congress originally estimated that the AMT would affect only one in 500,000 taxpayers. It based this projection on taxpayers with incomes of at least \$200,000 per year, an amount equivalent to slightly more than \$1,100,000 in 2004 dollars. The original estimate vastly understates the AMT’s current reach because Congress has (1) added numerous AMT adjustments and preferences; (2) failed to index the AMT exemption for inflation; and (3) decreased income tax rates, thus reducing regular income tax liabilities.

Although the AMT was aimed at wealthy taxpayers who use exclusions, deductions, and credits to avoid paying their “fair share” of tax, its real burden falls on middle-class taxpayers whose trust in the system’s fairness may erode significantly over time. This is particularly true when AMT liability varies based not on total income or deductions but on the types of those items, on the taxpayer’s occupation or employment status, or on the taxpayer’s state of residence.

The National Taxpayer Advocate recently reported that 65 percent of married couples

¹ This report refers to both the current version and the original add-on minimum tax as the Alternative Minimum Tax or AMT. The discussion covers the AMT only as it applies to individuals.

² Tax Reform Act of 1969, Pub. L. No. 91-172, § 301(a), 83 Stat. 487, 580-586. Several of those original preferences were later addressed by income tax amendments and eliminated from the AMT computation.

³ See generally I.R.C. §§ 53, 55-59.

with two or more children, and adjusted gross incomes between \$75,000 and \$100,000 will be subject to AMT by 2005.⁴ These individuals, and others described in this report, fall outside the original AMT target group. Unless Congress addresses the AMT problem, proposals to reduce income tax rates and make prior tax cuts permanent will further increase the number of AMT taxpayers. For these individuals, the so-called income tax cuts will prove to be a hollow promise.

The AMT Structure

Taxpayers pay the AMT in addition to income tax when AMT liability exceeds income tax liability. This determination requires a separate tax computation with its own rate structure, exemption, and treatment of several exclusions, deductions, and credits. Form 6251, used to compute AMT liability, requires entries on up to 35 lines. Taxpayers who report capital gains for income tax purposes may need to complete an additional 65 lines. Taxpayers begin with their Form 1040 taxable income (before personal exemptions) if they itemize deductions; otherwise they begin with their adjusted gross income (“AGI”). They add back up to 22 items and subtract up to four others.⁵ Several items require special computations.⁶ Taxpayers eligible for AMT credits use an additional form, Form 8801, to determine credits carried from prior years and to compute credits that will be carried to future years.

The paragraphs that follow briefly explain income tax and AMT differences. Some of the differences are permanent; others reflect separate timing rules. Some are consistent with Congress’s original goals for the AMT; many are not. All add to the tax system’s complexity.

Gross Income and Exclusions

The starting point for computing regular taxable income is gross income. Section 61(a) defines gross income as all income other than various excluded items (“exclusions”). For example, Section 102 generally excludes gifts from a recipient’s gross income for both income tax and AMT. Taxpayers who receive interest attributable to state and local government bonds that are private activity bonds exclude the interest for income tax but report it for the AMT.⁷ Taxpayers who exclude 50 percent of their gain on sales of “small business stock” for income tax lose seven percent of that exclusion for AMT.⁸ Those differences are permanent differences. Taxpayers who exercise incentive stock options in one year but sell the optioned stock in a later year are subject to AMT in the year of exercise but report no income for regular income tax until

⁴ See National Taxpayer Advocate, 2003 *Annual Report to Congress* 5 (Dec. 31, 2003) [hereinafter 2003 *Taxpayer Advocate Report*]. This report includes data prepared by government and outside sources. The Treasury Department estimates that, if the 2001 and 2003 tax cuts are made permanent, the AMT will increase the taxes of 3.3 million taxpayers in 2004, 16.2 million in 2005, and 46.4 million in 2014. *Fact Sheet: The Toll Of Two Taxes: The Regular Individual Income Tax And The AMT* (JS-1293, Apr. 2, 2004), available at <http://www.treasury.gov/press/>.

⁵ Because Line 26 adds back “Other” items, the number of potential additions actually exceeds 22.

⁶ For example, taxpayers use a 10-line worksheet to determine the AMT exemption amount.

⁷ I.R.C. §§ 57(a)(5), 103 & 141.

⁸ I.R.C. §§ 57(a)(7) & 1202.

they sell the stock. That difference is a timing difference.⁹

Deductions and Credits

Taxpayers use various deductions to reduce gross income to taxable income. Many deductions require a nexus to a business or income-producing activity. Others are allowed despite their purely personal character. Some deductions are subtracted directly from gross income in reaching AGI. Others are subtracted from AGI only if the taxpayer “itemizes” rather than taking a standard deduction. Still others, those for personal exemptions, are deducted from AGI in addition to the itemized or standard deduction amounts. Personal exemptions and itemized deductions are subject to phase-outs as AGI rises.¹⁰

Some income tax deductions are totally disallowed for AMT purposes; others are allowed but are subject to more stringent limitations. The former group includes the state, local, and foreign tax deduction, the deduction for miscellaneous itemized deductions, the standard deduction, and the deduction for personal and dependency exemptions.¹¹ The latter group includes deductions for medical expenses and home mortgage interest.¹² Because the AMT involves different depreciation methods, taxpayers deduct more depreciation for income tax in the earlier years of an asset’s life and more for AMT in the later years.¹³ The AMT has its own exemption, which phases out as taxpayer income rises.¹⁴

Credits resemble deductions in that both reduce tax liability. The major difference relates to their value. Because deductions reduce taxable income rather than the actual tax, their value depends on the taxpayer’s marginal tax rate. Because credits reduce the actual tax, a dollar of credit is worth a dollar of tax. As is true for gross income and deductions, both permanent and timing differences apply to income tax and AMT credits. For example, the AMT requires a separate computation for the foreign tax credit. It also provides for credit carryovers to reflect timing differences between income tax and AMT computations.¹⁵

Tax Rates

The income tax is applied at multiple rates, ranging from 10 percent to 35 percent;

⁹ I.R.C. §§ 56(b)(3), 421 & 422.

¹⁰ I.R.C. §§ 68 & 151(d)(3). *See also* I.R.C. §§ 67, 165(h) & 213(a).

¹¹ I.R.C. §§ 56(b)(1)(A)(ii) & 164(a) (taxes); I.R.C. §§ 56(b)(1)(A)(i) & 67 (miscellaneous itemized deductions); I.R.C. §§ 56(b)(1)(E) & 63(c) (standard deduction); and I.R.C. §§ 56(b)(1)(E) & 151 (exemptions).

¹² I.R.C. §§ 56(b)(1)(B) & 213(a) (medical expenses); I.R.C. §§ 56(b)(1)(C)(i), 56(e) & 163(h) (home mortgage interest).

¹³ I.R.C. §§ 56(a)(1), 57(a)(6) & 168.

¹⁴ I.R.C. § 55(d).

¹⁵ I.R.C. §§ 53 & 59

reduced rates apply to long-term capital gains and dividends. The AMT is applied at two rates, 26 percent on the first \$175,000 of AMT income and 28 percent on any remaining AMT income. The income brackets to which income tax rates apply are indexed for inflation and vary based on filing status; AMT brackets are not indexed for inflation and do not vary based on filing status.¹⁶

Although the AMT Raises Revenue, It Does Not Fulfill Its Original Purpose

The AMT generates a significant amount of tax revenue. Multi-year cost estimates indicate that repeal could cost as much as one trillion dollars through 2014. The Treasury Department estimates that less revenue would be lost in 2013 by repealing the regular income tax than by repealing the AMT.¹⁷ Revenue loss estimates vary because estimators can't predict which income tax cuts will be made permanent, but it is clear the amount is considerable.

Given its revenue contribution, the AMT might be justified if it served its original purpose. Various government studies indicate that it has failed. As stated in one study, "If the goal is to make everyone with a high income pay some federal income tax, experience suggests the AMT is not the way to achieve it."¹⁸ This report does not suggest adding preferences or making other changes to return the AMT to its original design, a tax that applies only to designated high-income individuals, but that is an option Congress can explore.

If revenue concerns prevent its outright repeal, Congress should address the tax and other burdens that the AMT imposes on middle-income taxpayers. As this report illustrates, those taxpayers are subject to the AMT not because they use tax shelters but because they have children, pay their state income taxes, or go to the doctor.

AMT Compliance Costs

Commentators within and outside the government frequently criticize the AMT. In her 2003 report to Congress, the National Taxpayer Advocate identified it as the most serious problem encountered by taxpayers.¹⁹ Joint Economic Committee, Joint Committee on Taxation, and General Accounting Office personnel have reported its problems.²⁰ Acting Treasury

¹⁶ Compare I.R.C. § 1 with I.R.C. § 55.

¹⁷ See Leonard E. Burman, William G. Gale, Jeffrey Rohaly & Matthew Hall, *Key Points on the Alternative Minimum Tax*, Jan. 21, 2004 (Urban-Brookings Tax Policy Center), available at <http://www.brookings.edu/views/op-ed/gale/20040121amt.htm>; *Fact Sheet: The Toll Of Two Taxes*, *supra* note 4.

¹⁸ Kurt Schuler, Senior Economist to the Chairman, *The Alternative Minimum Tax for Individuals: A Growing Burden* 8 (Joint Economic Comm. Study May 2001). In 1998 "*the AMT added just one high-income taxpayer to the income tax rolls for every 1,000 already paying the regular income tax.*" *Id.* (italics in original).

¹⁹ 2003 *Taxpayer Advocate Report*, *supra* note 4, at 5-19. See also National Taxpayer Advocate, *FY 2001 Annual Report to Congress* (Dec. 31, 2001) [hereinafter *2001 Taxpayer Advocate Report*], at 166-77, recommending repeal or significant amendment of the AMT.

²⁰ See *The Alternative Minimum Tax for Individuals: A Growing Burden*, *supra* note 18; Staff of Joint Comm. on Tax'n, *Study of the Overall State of the Federal Tax System and Recommendations for Simplification, Pursuant to Section 8022(3)(B) of the Internal Revenue Code of 1986* (JCS 3-01, Apr. 2001), vol. II, at 2-10;

Assistant Secretary for Tax Policy Gregory F. Jenner has indicated that it “absolutely has to be dealt with.”²¹ Business journalists regularly highlight its complexity, effect on middle-income taxpayers, and other burdens.²²

The compliance costs associated with the AMT are significant. They include the use of paid preparers or commercial software solely to compute the AMT and increased need for professional planning assistance by those hoping to avoid or minimize it. Some taxpayers, including non-itemizers and those whose tax returns include one-time income or expense items, may first encounter the AMT in an IRS notice of deficiency. In addition to additional tax liability, those taxpayers face interest and penalty costs.

AMT compliance costs burden even taxpayers with no AMT liability. Determining whether AMT liability exceeds regular tax liability involves more than comparing gross income, AGI, or taxable income to a preset “eligibility” amount. Taxpayers must recompute many income tax return items merely to determine if they are subject to AMT.²³ Many taxpayers must maintain additional records to reflect timing differences between regular and AMT liability.

Taxpayers are not the only group burdened by AMT compliance costs. Government personnel, including tax examiners, appeals officers, and trial attorneys, are diverted from other functions to assist in administering the AMT.²⁴ The Taxpayer Advocate has reported a significant increase in Tax Court cases involving the AMT.²⁵

Other AMT Problem Areas

Problems associated with the AMT extend beyond compliance costs. They include increased taxation of middle-income taxpayers and taxpayers with family responsibilities, counterintuitive outcomes, unnecessary distinctions between similarly situated taxpayers, and taxation of “phantom” income. The discussion that follows focuses on several of these problems.

Statement of James R. White, Director, Tax Issues, General Accounting Office, Before the Senate Comm. on Finance, *Alternative Minimum Tax: Overview of Its Rationale and Impact on Individual Taxpayers* (GAO-01-500T, Mar. 8, 2001) (based on a prior GAO report of the same name, available as GAO/GGD-00-180, Aug. 15, 2000).

²¹ See TAX NOTES, Mar. 8, 2004, at 1195. See also Robert Rebelein & Jerry Tempalski, *Who Pays the Individual AMT?* (OTA Paper 87, June 2000) (OTA papers do not necessarily represent official Treasury Department positions).

²² See, e.g., Howard Gleckman, *The Stealth Tax*, BUS. WK., Feb. 16, 2004, at 86; *What Tax Cut? Meet the AMT*, at http://money.cnn.com/2004/02/25/pf/taxes/amt_stories/ (Feb. 26, 2004); Shawn Tully, *Taxpayer Beware!; Washington will soon be taking back a good chunk of that new tax cut. How? By using the sneakiest trap it's got: the Alternative Minimum Tax*, FORTUNE, June 23, 2003, at 48; Ashlea Ebeling & Janet Novack, *Killer Tax*, FORBES, Apr. 1, 2002, at 72.

²³ These problems were predicted before Congress enacted the original, relatively simple, AMT. See Staff of Joint Comm. on Tax'n, *Summary of Testimony on Minimum and Maximum Taxes* 6-8 (JCS-18-69, July 11 1969).

²⁴ Statement of James R. White, *supra* note 20, at 9.

²⁵ *2001 Taxpayer Advocate Report*, *supra* note 19, at 172.

It highlights taxpayers whose situations were not part of Congress's rationale in enacting the AMT and who are now "accidental" AMT taxpayers. Imposing AMT on these taxpayers often undermines congressional policies that the income tax advances. Other affected taxpayers may have been within Congress's original AMT target group. Because of changes in compensation patterns and other factors unrelated to tax avoidance, these taxpayers may also merit relief. The following paragraphs discuss AMT problems associated with particular groups of taxpayers and suggest possible means of addressing those problems if repeal is not feasible.

Middle-Income Taxpayers

In enacting the original AMT, Congress focused on taxpayers whose AGI exceeded \$200,000. Adjusting that figure to reflect inflation since 1969, the appropriate target group would be taxpayers whose AGI exceeds \$1,100,000.

When the AMT was first enacted, the income tax personal exemption was \$600. In 1981, Congress began adjusting that exemption for inflation; the 2004 amount is \$3,100. Although the exemption phases out as a taxpayer's AGI rises, the phase-out begins at a relatively high AGI level, and that level is adjusted annually for inflation.²⁶ By contrast, the AMT exemption was \$30,000 in 1969. Congress has increased it a few times since then and never indexed it for inflation. The AMT exemption for married couples, temporarily increased by legislation to \$58,000 for 2003 and 2004, is scheduled to fall to \$45,000 in 2005.²⁷ If Congress had increased the AMT exemption along with the income tax exemption, it would now be \$155,000.

Not only is the current AMT exemption low, it phases out as a taxpayer's alternative minimum taxable income (AMTI) increases. Although the AMTI base is larger than the regular income tax base, the AMT exemption phase-out begins at lower income levels, occurs at a much faster rate, and contains no inflation adjustment. Unmarried taxpayers with no income tax deductions other than personal exemptions and the standard deduction lose at least part of their AMT exemption when AMTI exceeds \$112,500 (\$150,000 for married couples filing jointly).

Because marginal income tax rates are lower in 2004 than they were in 1969, Congress may consider \$1,100,000 too high an income level for full AMT relief or \$155,000 too high an exemption. But it cannot ignore the fact that taxpayers now pay AMT based on income that, without any adjustment for inflation, is well below the level targeted in 1969. Congress could eliminate non-targeted taxpayers from the AMT system by (1) enacting an income floor or (2) increasing the AMT exemption. Although each alternative reduces the number of taxpayers subject to AMT, an income-based floor also reduces the number of taxpayers who must compute potential AMT liability.²⁸ These solutions will be only stop-gaps, however, unless Congress also

²⁶ I.R.C. § 151(d)(3) & (4). The phase-out for 2004 begins at AGI of \$214,050 for married taxpayers filing joint returns and surviving spouses (\$178,350 for heads of household and \$142,700 for other unmarried individuals). Rev. Proc. 2003-85, 2003-49 I.R.B. 1184.

²⁷ I.R.C. § 55(d)(1).

²⁸ The Taxpayer Advocate has discussed both gross income and adjusted gross income thresholds and ultimately recommended a gross income threshold. She acknowledged that AGI, a specifically identified tax return

provides automatic inflation adjustments for the particular item (income floor or AMT exemption), including any income phase-out applied to the AMT exemption.²⁹

Taxpayers Who Have Family Responsibilities

Congress provides significant income tax relief for taxpayers with children. This relief includes deductions (dependency exemption and medical expense), credits (adoption, child, dependent care, earned income), and tax rates (surviving spouse and head of household). Taxpayers can cover dependents under employer-provided fringe benefits programs. Many of these tax benefits were enacted after the AMT.

Assuming their other deductions and credits are the same, taxpayers with large families pay less income tax than do taxpayers who have the same gross income (amount and type) but smaller families. By eliminating personal exemption deductions, the AMT harms taxpayers whose incomes, when considered in relation to their family size, are relatively modest.³⁰

Recognizing that unmarried taxpayers bear additional costs if they maintain a household that includes other family members, Congress provides a special income tax rate structure and standard deduction for them.³¹ Qualifying taxpayers must provide more than one-half of the costs of maintaining a home that is the principal place of abode of both the taxpayer and either a child or a dependent.³² The rate structure and standard deduction for heads of household are more generous than those for other single individuals but less generous than those for married individuals filing a joint return and surviving spouses.

Because all unmarried individuals use the same AMT exemption and exemption phase-out floor, heads of household are treated exactly the same as single individuals with identical incomes. The AMT ignores their extra household costs.³³ Heads of household already use a separate standard deduction and rate schedule in computing their income tax liability. A separate, higher AMT exemption would reduce their tax burden without increasing complexity.

line, would be simpler for taxpayers but would benefit taxpayers taking certain preference items as deductions in computing AGI. *2003 Taxpayer Advocate Report*, *supra* note 4, at 17-18.

²⁹ Eliminating the phase-out altogether would simplify the AMT computation further, but Congress might decide that the potential tax savings flowing to high-income taxpayers outweigh the benefits of simplification.

³⁰ The Taxpayer Advocate noted that a mother of five who earned \$45,000 in 2000 and was required to use married filing separate status (because she was separated for less than six months) owed \$1,850 in AMT. *2001 Taxpayer Advocate Report*, *supra* note 19, at 168. *Klaassen v. Commissioner*, 76 T.C.M. (CCH) 20 (1998), involved a couple with 10 children. Based on an AGI of \$83,056, itemized deductions (including medical expenses and state and local taxes), and 12 personal exemptions, they owed \$5,111 in income tax and an additional \$1,085 in AMT. The AMT reduced their medical expenses and disallowed their state and local taxes and personal exemptions.

³¹ I.R.C. §§ 1(b) & 63(c)(2)(B).

³² I.R.C. § 2(b). The taxpayer can also qualify by maintaining a separate home for a dependent parent.

³³ In contrast, single individuals who are surviving spouses use the AMT exemption applied to married couples filing a joint return. I.R.C. § 55(d)(1)(A).

Taxpayers Who Itemize Deductions

Taxpayers are currently allowed income tax deductions for a variety of business, investment/income-producing, and personal expenses. These deductions are subject to a number of limitations, many of which are based on AGI. For AMT purposes, some itemized deductions are allowed, but subject to different limitations; others are disallowed entirely. In addition to contributing to complexity, the separate AMT rules differentiate between taxpayers based on factors totally unrelated to the AMT's purpose. Congress could reduce the complexity illustrated in the following paragraphs by applying the same deduction limitations to both taxes, adopting whichever tax's current limitation best supports its goals.

Taxpayers Who Have High Medical Expenses

Two major limitations apply to the income tax deduction for medical expenses. First, unreimbursed expenses are deductible only to the extent they exceed 7.5 percent of AGI, thus limiting deductions to "extraordinary" expenses. Second, nonprescription drugs (other than insulin) are not deductible.³⁴ In determining AMT liability, taxpayers must reduce their medical expenses further; the deduction floor for AMT purposes is 10 percent of AGI.³⁵

In addition to the extra computation burden, the current AMT rules penalize taxpayers who are unable to participate in tax-advantaged health savings plans. Taxpayers who participate in these plans can direct amounts that would otherwise be taxable salary into accounts used to reimburse them for medical expenses on a tax-free basis.³⁶ Those amounts avoid both the 7.5 percent income tax floor and the additional 2.5 percent floor used for AMT purposes. If they use these accounts to purchase nonprescription drugs, they can also avoid that limitation.³⁷

The current structure for medical expense deductions favors taxpayers who are financially able to use these plans for future medical expenses and who are sophisticated enough to understand the tax advantages of doing so. The benefits they enjoy go beyond avoiding medical expense deduction limitations. Because they reduce AGI by the amount contributed to these plans, they increase their ability to qualify for other AGI-limited tax benefits and they decrease both the income tax and AMT tax bases. Because taxpayers in the AMT target group can use these plans to avoid any deduction floor, it is questionable whether the separate AMT floor reduces tax avoidance enough to justify the additional complexity and tax imposed on taxpayers who can't avail themselves of these plans.

Taxpayers Who Live in High-Tax States

Taxpayers who pay state and local income or property taxes can deduct these taxes in

³⁴ I.R.C. § 213(a) & (b).

³⁵ I.R.C. § 56(b)(1)(B).

³⁶ I.R.C. § 125. Similar benefits are available to taxpayers who qualify for and can afford to use Archer MSAs or Health Savings Accounts. *See* I.R.C. §§ 220 & 223.

³⁷ Rev. Rul. 2003-102, 2003-38 I.R.B. 559.

computing income tax but must add them back when computing AMT. This add-back affects taxpayers living or owning property in high-tax states more severely than it does those from low-tax states. This AMT add-back increases both tax liability and complexity with respect to an involuntary outlay. If the AMT were designed to affect deductions using a voluntary/involuntary distinction, it would apply to charitable contributions rather than to state and local taxes. Instead, charitable contribution deductions are treated the same way for both taxes.

Congress could eliminate both complexity and the increased AMT tax by treating state and local taxes the same for AMT purposes as for income tax purposes. If it determined that approach would create a windfall for wealthy taxpayers, Congress could limit their overall benefit by limiting property tax deductions for both taxes.

Taxpayers Whose Employers Do Not Reimburse Their Business Expenses

Most unreimbursed employee business expenses are treated as “miscellaneous itemized deductions” along with such items as tax return preparation fees and safe deposit boxes for investment assets. These items can be deducted for income taxes only to the extent their total exceeds two percent of AGI. None of that total is deductible in computing AMT.³⁸ These rules exacerbate a disparity between employees and self-employed individuals; the latter escape both income tax and AMT deduction limits.³⁹

Certain employee groups avoid both the income tax and AMT limitations because they qualify for special treatment. If an employee is a qualified performing artist, a state or local official compensated at least in part on a fee basis, or an Armed Forces reservist traveling away from home, that employee’s unreimbursed expenses are not itemized deductions.⁴⁰ Because they are deductible in computing AGI, these deductions are not added back in computing AMT.

The current treatment also favors taxpayers whose employers provide (or reimburse) their business supplies, tools, and dues and pay lower wages over employees who receive higher wages but must pay their own expenses. An employee who receives salary of \$100,000 and must pay for \$3,000 in employment expenses is financially in the same situation as an employee who receives \$97,000 and whose employer pays the \$3,000 in expenses. The two employees have quite different tax situations. The first employee has gross income of \$100,000; unless the employee has other miscellaneous itemized deductions, only \$1,000 of the \$3,000 is deductible. The second employee reports only \$97,000 of gross income. For AMT purposes, the first employee reports income (before the exemption) of \$100,000; the second, only \$97,000.⁴¹

³⁸ I.R.C. §§ 56 (b)(1)(A)(i) & 67.

³⁹ See, e.g., *D’Acquisto v. Commissioner*, 80 T.C.M. (CCH) 149 (2000).

⁴⁰ I.R.C. § 62(a)(2)(B)-(E).

⁴¹ See *Birts v. Commissioner*, T.C. Summary Opinion 2001-77. The taxpayer’s \$37,850 AGI was solely from wages, but he had \$26,903 of unreimbursed employee business expenses. He owed \$619 in income tax; AMT of \$2,982 pushed his liability to \$3,601. The example in the text assumes that each employee’s gross income equals that employee’s AGI.

Taxpayers Who Borrow Using Home Equity Loans

For income tax, a taxpayer can deduct interest paid on debt incurred to acquire, construct, or improve both a principal residence and a second residence used for personal purposes. A taxpayer can also deduct interest on home equity indebtedness secured by those residences even if the funds were not spent to acquire, construct, or improve one of the residences.

Taxpayers who use home equity loans to help pay their children's tuition or repay high-interest credit card debt can take an income tax deduction for interest on up to \$100,000 of such debt. Unless the loan is used to acquire, construct, or improve the residence, they cannot take an AMT deduction.⁴² Given the \$100,000 cap on such debt, the income tax savings attributable to these loans is relatively small. Applying the same limitations to income tax and AMT would reduce complexity and might also protect taxpayers from unexpected AMT liability.⁴³

Taxpayers Whose Recoveries Include Attorneys' Fees

Taxpayers who receive judgments or settlements for tort or other injuries report as gross income all punitive damages and all compensatory damages that are not attributable to personal physical injury or physical sickness. Compensatory damages attributable to personal physical injury or physical sickness are excluded from gross income.⁴⁴ Taxpayers who pay attorneys' fees to recover damages can deduct the portion of the fee attributable to taxable damages; they cannot deduct fees attributable to damages that are excluded from gross income.⁴⁵

If the attorneys' fees were fully deductible, they would reduce the taxable award to the net damage amount. This rule currently applies to fees incurred by self-employed individuals who recover business damages.⁴⁶ Other taxpayers can deduct the fees only if they itemize and only as a miscellaneous itemized deduction subject to the two percent of AGI floor discussed previously. A taxpayer who received \$10,000 in taxable damages, but paid \$3,000 to the attorney, would report \$10,000 of gross income even though the taxpayer retained only \$7,000. If that taxpayer had total AGI (including the damages) of \$80,000, and no other miscellaneous itemized deductions, only \$1,400 (the amount exceeding two percent of the \$80,000 AGI) would be deductible for income tax purposes; none of it would be deductible for AMT. A taxpayer whose AGI was \$150,000 or more could deduct none of the fee in computing either tax.

Because the circuit courts disagree regarding the appropriate treatment of attorneys' fees, the rules described above do not apply uniformly. Taxpayers in most jurisdictions must include

⁴² Compare I.R.C. § 163(h) with I.R.C. § 56(b)(1)(C).

⁴³ Form 1098, which lenders use to report mortgage interest, contains no information about AMT liability. As a result, taxpayers who have home equity loans may be totally unaware of their potential liability.

⁴⁴ I.R.C. § 104(a)(2).

⁴⁵ I.R.C. §§ 212(1) & 265.

⁴⁶ See *Guill v. Commissioner*, 112 T.C. 325 (1999).

the full award in gross income.⁴⁷ Three circuit courts have allowed taxpayers to report the award net of attorneys' fees.⁴⁸ Taxpayers in those jurisdictions avoid both the income tax and AMT deduction limitations. One circuit resolves these cases on a state-by-state basis, looking to the attorneys' rights under state law.⁴⁹ The Supreme Court is likely to resolve the inter-circuit split during its next term.⁵⁰

Any taxpayer forced to include these fees in gross income suffers some tax detriment. Taxpayers awarded nominal damages who are eligible for attorneys' fees under fee-shifting statutes are particularly disadvantaged. Because of the AMT, their tax liability can exceed their damage award.⁵¹

Legislative options for addressing the treatment of attorneys' fees include excluding them from the client's gross income; allowing attorneys' fees as a deduction in computing AGI; or eliminating attorneys' fees as an item added back in computing AMT.

Taxpayers Who Realize Long-Term Capital Gains

Congress uses the income tax to encourage long-term investments in stocks, bonds, and other investment assets. The maximum tax rate applied to most long-term capital gain (LTCG) income, which requires a holding period that exceeds one year, is 15 percent.⁵² Taxpayers who sell their property earlier apply their normal income tax rates to their gains. The AMT offers the same lower rates for LTCGs, albeit through an extensive set of computations. As noted earlier in this report, taxpayers reporting LTCGs face not only the 35-line main AMT computation but up to 65 additional lines to determine their AMT liability.

Although the AMT nominally preserves lower tax rates for LTCGs, its actual effect on middle-income taxpayers is not so beneficial. Although LTCG income qualifies for reduced rates, it is still included in gross income. The LTCG income, and any resulting state income taxes (which are not deductible for AMT purposes), adversely affect the taxpayer's ability to take the

⁴⁷ *Alexander v. Internal Revenue Service*, 72 F.3d 938 (1st Cir. 1995); *Raymond v. United States*, 355 F.3d 107 (2d Cir. 2004); *O'Brien v. Commissioner*, 319 F.2d 532 (3d Cir. 1963); *Young v. Commissioner*, 240 F.3d 369 (4th Cir. 2001); *Kenseth v. Commissioner*, 259 F.3d 881 (7th Cir. 2001); *Bagley v. Commissioner*, 121 F.3d 393 (8th Cir. 1997); *Hukkanen-Campbell v. Commissioner*, 274 F.3d 1312 (10th Cir. 2001), *cert. denied*, 535 U.S. 1056 (2002); *Baylin v. United States*, 43 F.3d 1451 (Fed. Cir. 1995).

⁴⁸ *Srivastava v. Commissioner*, 220 F.3d 353 (5th Cir. 2000); *Estate of Clarks v. United States*, 202 F.3d 854 (6th Cir. 2000); *Banks v. Commissioner*, 345 F.3d 373 (6th Cir. 2003); *Foster v. United States*, 249 F.3d 1275 (11th Cir. 2001).

⁴⁹ *Compare Banaitis v. Commissioner*, 340 F.3d 1074 (9th Cir. 2003) (Oregon law) with *Coady v. Commissioner*, 213 F.3d 1187 (9th Cir. 2000), *cert. denied*, 532 U.S. 972 (2001) (Alaska law), and *Benci-Woodward v. Commissioner*, 219 F.3d 941 (9th Cir. 2000), *cert. denied*, 531 U.S. 1112 (2001) (California law).

⁵⁰ On March 29, 2004, the Court granted the government's petition for certiorari in *Banks* and *Banaitis*.

⁵¹ See *Porter v. United States Agency for Int'l Dev.*, 293 F. Supp. 2d 152 (D.D.C. 2003) (damages of \$30,000; attorneys' fees and costs exceeding \$200,000).

⁵² I.R.C. § 1(h). Even lower rates apply to taxpayers whose top income rate is below 25 percent.

AMT exemption. One recent study determined that the increased AMT tax attributable to LTCG income exceeded the so-called maximum rate applied to these gains. And, for taxpayers whose other income remained constant, the effective AMT rate was higher on LTCG income of \$200,000 (21.5 percent) than on LTCG income of \$500,000 (16.58 percent).⁵³

Taxpayers Who Exercise Incentive Stock Options (ISOs)

As a general rule, taxpayers who own appreciated property do not report “paper” gains as gross income. Taxpayers report these gains only when they realize them by selling the property. And, as discussed in the preceding section, they may qualify for a reduced rate if the property sold qualifies for long-term capital gain treatment.

Taxpayers who exercise ISOs are subject to different rules. Because they report AMT income even though they still hold their stock, they report AMT income before they realize gross income subject to income tax.⁵⁴ Their AMT income includes the difference between the exercise price for the ISO stock and its fair market value on the exercise date. If the ISO adjustment is large enough, or they have other AMT items, they become subject to AMT. The ISO income is ordinary income; it does not qualify for the AMT tax rate applicable to long-term capital gains.

Unless these taxpayers sell their stock, they may lack funds to pay the AMT. Selling the stock in the year of exercise may solve the cash flow problem, but it forces taxpayers to disinvest from their companies and makes them ineligible for long-term capital gains treatment.⁵⁵ If they can avoid selling prematurely, they qualify for an AMT credit to use against the income tax due when they sell the stock. Because that credit is a deferred benefit, it provides no relief in the year of exercise. In addition, it may prove worthless if the stock value plummets before the sale.⁵⁶

Although stock options have been targeted by the AMT since its inception, ISOs are not reserved for small groups of sophisticated employees.⁵⁷ The hardships associated with the AMT are borne by many taxpayers whose other compensation and assets are relatively modest.⁵⁸ Relief

⁵³ See Yvonne L. Hinson & Ralph B. Tower, *Influence of Long-Term Capital Gains on Individual AMT*, TAX NOTES, Jan. 19, 2004, at 403, 405. They based their computations on a married couple with three children, living in North Carolina, whose 2003 AGI before capital gains was \$178,001.

⁵⁴ I.R.C. §§ 56(b)(3) & 421.

⁵⁵ Employees who sell prematurely lose ISO status for the shares sold. I.R.C. § 422. Although their only “penalties” are immediate taxation and loss of long-term capital gains status, unsophisticated employees may fail to sell because they believe premature sales are prohibited.

⁵⁶ Some taxpayers may never fully recover the AMT attributable to their ISOs. Because the AMT net capital loss deduction is limited to \$3,000 per year, taxpayers may wait years to benefit from a loss. AMT credits are available only in years in which the income tax exceeds the AMT and only up to the amount of that excess.

⁵⁷ I.R.C. § 422(b). Although it is a matter of semantics, the AMT classifies ISO income as an adjustment rather than as a preference.

⁵⁸ The Taxpayer Advocate reported the situation of a computer programmer who exercised ISOs and was subject to AMT exceeding \$520,000. By the following year, she could not pay the tax. The stock value had “dropped sharply,” and she had lost her job. *2003 Taxpayer Advocate Report*, *supra* note 4, at 15.

for ISO recipients could take a variety of forms, including postponing the AMT inclusion until the stock is sold or allowing an AMT refund in the year ISO stock is sold at a loss.

Taxpayers Who Purchase Depreciable Property

The depreciation deduction for business and income-producing property other than real estate is based on an accelerated depreciation method (generally, declining balance depreciation at 200 percent of the straight line rate). AMT depreciation is based on declining balance depreciation at 150 percent of the straight line rate, so it provides a smaller deduction in an asset's early years. Because the depreciation deduction reduces the taxpayer's basis in the asset, the basis for income tax declines faster than the basis for AMT. These differences eventually reverse themselves. A taxpayer remains entitled to AMT depreciation deductions after fully depreciating an asset for income tax. A taxpayer who sells assets that are not fully depreciated for AMT purposes reports a different gain or loss for each of the two taxes.⁵⁹

During the ownership period, the taxpayer has additional recordkeeping and computation costs. Because businesses with significant depreciable assets already use computerized tracking systems, the compliance burden primarily falls on small businesses.

Taxpayers Who Can Accelerate or Defer Income and Deductions

As a general rule, taxpayers who can shift income and deductions are advised to defer income into future years and accelerate deductions into earlier years. Even if tax rates are the same each year, this strategy is beneficial because of the time value of money; the early-year tax savings can be invested or used for other purposes. Because AMT tax rates start higher and are less-graduated than income tax rates, taxpayers subject to AMT may benefit from reversing their strategy.

Consider, for example, a married couple with 2004 wage income of \$200,000 and no dependents. If they paid state and local income and property taxes of \$21,000, their taxable income would be \$174,519 and their income tax would be \$38,823. Their alternative minimum taxable income would be \$154,500; the AMT will increase their taxes due by \$1,347, resulting in total liability of \$40,170. A tax planner would advise them that they could achieve federal tax benefits by not paying \$4,700 of the state and local taxes until 2005. Unless they can afford sophisticated tax advice, taxpayers are unlikely to adopt such counterintuitive behavior.⁶⁰

Corporate AMT

Finally, it should be observed that the corporate AMT suffers from infirmities similar to the individual AMT. The corporate AMT requires corporations to keep at least two sets of

⁵⁹ I.R.C. §§ 56(a)(1) & (6).

⁶⁰ The couple would be in the 28 percent income tax bracket and the 26 percent AMT bracket. Their 2004 income tax would still be less than their AMT if they shifted \$4,700 in state and local taxes to 2005. Although they reach the 33 percent income tax bracket, the income tax on taxable income of \$179,219 is only \$40,167. Their total tax is unchanged and they gain potential deductions for 2005 in case the AMT doesn't apply to them then.

books for tax purposes, imposes myriad other burdens on taxpayers (especially those with significant depreciable assets) and has the unintended effect of taxing struggling or cyclical companies at a time when they can least afford it. If repeal of the corporate AMT leaves specific concerns unaddressed, those concerns should be addressed directly by amending the Code instead of preserving a system that is unduly complex; that fails to fulfill its original intent of imposing the AMT only on corporations with high incomes; and that subjects corporate taxpayers to the additional burden of computing their tax liability twice.

The Section of Taxation is in the process of considering a resolution with respect to the corporate AMT similar to the one contained herein with respect to the individual AMT.

Revenue Offsets

It is recognized that the revenue impact associated with repeal or modification of the AMT will result in Congress evaluating appropriate alternative revenue sources. The resolutions and this report do not include an examination of different methodologies for revenue generation that might be applied against any revenue losses resulting from the implementation of the resolutions. Although any adjustments would reflect various economic, social and political considerations, they should promote simplification and should be administrable in an equitable manner consistent with the intended consequences.

Summary

Tax Simplification is one of the American Bar Association's Legislative and Government Priorities. Simplification is important in meeting the goal that tax laws should "be easily understood and complied with by the taxpayers and fairly and consistently administered and enforced by the Treasury Department."⁶¹ The federal income tax is not a simple tax to compute. In determining their liability, taxpayers must deal with dollar limitations, percentage limits, various phase-outs, and special rates. The AMT's complexity magnifies their burdens. It requires them to expend substantial resources on return preparation and recordkeeping and limits their ability to plan rationally. Even taxpayers with no AMT liability must engage in extensive computations to determine they are exempt. Taxpayers are not shielded from interest and penalties by their ignorance of the AMT.

If the AMT applied only to its original target group, extremely high-income individuals who paid little or no tax, perhaps its costs could be justified. Those individuals are more sophisticated and can afford professional advice and other costs associated with complexity. But reports indicate that many of them avoid both income tax and AMT, while government resources are expended administering the AMT's application to middle-income taxpayers.

The AMT imposes additional taxes on taxpayers who lack the financial wherewithal to pay. Taxpayers who recover nominal damages for asserting their rights may pay more in tax than they actually recover. Taxpayers who exercise ISOs must sell their shares prematurely or be taxed on paper gains. Those who hold their stock risk plunging stock values, which wipe out their ability to use AMT credits.

⁶¹ American Bar Association, *2004 Legislative and Governmental Priorities*.

The AMT draws arbitrary distinctions between taxpayers. It favors taxpayers who can afford to make charitable gifts over those whose funds are needed to pay medical expenses or state and local taxes. It favors taxpayers whose employers provide tax-advantaged health plans over those whose employers do not. It favors taxpayers whose employers provide business supplies and pay lower wages over those whose employers pay higher wages instead of furnishing those supplies. It favors taxpayers who can afford tax advice over those who cannot or who do not realize that they need advice. Because reducing AMT may require taxpayers to ignore traditional tax-savings strategies, such advice is essential.

Because its components are not indexed for inflation, the AMT applies to an ever-increasing group of middle-income taxpayers, eroding the income tax cuts Congress enacted for them. Its treatment of personal exemptions and heads of household adversely affects individuals with family responsibilities, undermining congressional policies reflected in the income tax.

Recommended Legislative Action

By repealing or significantly amending the individual AMT, Congress can reduce the complexity that results in increased compliance costs and tax return errors. It can reduce or eliminate distinctions that are not based on ability to pay tax or other rational tax policy. It can restore income tax benefits it has advertised to taxpayers. Without such legislation, the costs associated with this tax will continue to escalate.

Richard A. Shaw, August 2004

GENERAL INFORMATION FORM

Submitting Entity: Section of Taxation

Submitted By: Richard A. Shaw

1. Summary of Recommendation

That Congress reduce the federal tax burdens and compliance costs attributable to the Alternative Minimum Tax (AMT) on individuals by repealing the individual AMT, or, if repeal of the individual AMT is not feasible then the individual AMT should be modified in a manner consistent with its original purpose to ensure that the AMT applies only to designated high-income individuals.

2. Approval by Submitting Entity

The Recommendation is submitted contingent on approval by the Council of the Section on May 6, 2004 and the Section Membership at its May 6-8, 2004 May Meeting.

3. Has this or a similar recommendation been submitted to the House or Board previously?

No.

4. What existing Association policies are relevant to this recommendation and how would they be affected by its adoption?

It is Association policy that Congress should simplify the federal tax laws "to the maximum extent consistent with basic equity, efficiency, and the need for revenue, so that such laws can be easily understood and complied with by taxpayers". *101 ABA Repts. 690 and 110 ABA Repts. 579*. This policy would be furthered by this legislative recommendation because full repeal of the individual AMT, or modification so that it applies only to high-income taxpayers, would reduce tax compliance burdens and costs for many taxpayers.

5. What urgency exists which requires action at this meeting of the House?

Legislation has been introduced in Congress, and the Administration and Congress have both publicly recognized the AMT's burdens upon taxpayers.

6. Status of Legislation

H.R. 4164 - A bill to amend the Internal Revenue Code of 1986 to index for inflation the exemption amount for individuals under the alternative minimum tax and to repeal the

alternative minimum tax on individuals in 2010 was referred to the House Ways and Means Committee on April 2, 2004.

H.R. 4131 - The Alternative Minimum Tax Repeal Act of 2004 was referred to the House Ways and Means Committee on April 2, 2004.

7. Cost to the Association.

None.

8. Disclosure of Interest.

No member of the originating Task Force or the Council of the Section of Taxation is known to have a material interest in the resolution by virtue of a specific employment or engagement to obtain the results of the resolution.

9. Referrals.

All sections and divisions.

10. Contact Persons

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12. Contact person regarding amendments to this recommendation.

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Executive Summary

a) Summary of the recommendation

That Congress reduce the federal tax burdens and compliance costs attributable to the Alternative Minimum Tax (AMT) on individuals by repealing the individual AMT, or, if repeal of the individual AMT is not feasible then the individual AMT should be modified in a manner consistent with its original purpose to ensure that the AMT applies only to designated high-income individuals.

b) Summary of the issue which the recommendation addresses

The AMT's complexity magnifies taxpayer burdens. It requires them to expend substantial resources on return preparation and recordkeeping and limits their ability to plan rationally. Even taxpayers with no AMT liability must engage in extensive computations to determine they are exempt. Taxpayers are not shielded from interest and penalties by their ignorance of the AMT.

Because its components are not indexed for inflation, the AMT applies to an ever-increasing group of middle-income taxpayers, eroding the income tax cuts Congress enacted for them. Its treatment of personal exemptions and heads of household adversely affects individuals with family responsibilities, undermining congressional policies reflected in the income tax. If the AMT applied only to its original target group, extremely high-income individuals who paid little or no tax, perhaps its costs could be justified. Those individuals are more sophisticated and can afford professional advice and other costs associated with complexity. But reports indicate that many of them avoid both income tax and AMT, while government resources are expended administering the AMT's application to middle-income taxpayers.

The AMT draws arbitrary distinctions between taxpayers. It favors taxpayers who can afford to make charitable gifts over those whose funds are needed to pay medical expenses or state and local taxes. It favors taxpayers whose employers provide tax-advantaged health plans over those whose employers do not. It favors taxpayers whose employers provide business supplies and pay lower wages over those whose employers pay higher wages instead of furnishing those supplies. It favors taxpayers who can afford tax advice over those who cannot or who do not realize that they need advice. Because reducing AMT may require taxpayers to ignore traditional tax-savings strategies, such advice is essential.

c) Explanation of how the proposed policy position will address the issue

By repealing or significantly amending the individual AMT, Congress can reduce the complexity that results in increased compliance costs and tax return errors. It can reduce or eliminate distinctions that are not based on ability to pay tax or other rational tax policy. It can restore income tax benefits it has advertised to taxpayers. Without such legislation, the costs associated with this tax will continue to escalate.

d) Summary of any minority views or opposition which have been identified

No minority views were expressed.