

Today: US Individual Income Tax
(same from Ch. 18)

Taxing income from labor
supply (wages & salaries),
interest earnings on savings,
dividends, non-corp. business profit,
(capital gains, etc.

Next Time: Back to Neary analysis of taxing
income from labor supply and interest
earnings on savings.
(Based on Ch. 21 & 22).

After that, Ch. 23.

US Individual Income Tax

(a) Structure of Form 1040.

Key vocabulary: Exemptions,
standard deduction, itemized
deduction, tax credit,
refundable (or non-refundable)
tax credit, AGI, TI,
AMT

(b) Key data

(c) Computing the tax owed
Bracket / Rate structure.

(d) Alternative Minimum Tax.

(e) Incentive effects of tax
deductions and credits.

Label

(See instructions on page 16.) Use the IRS label. Otherwise, please print or type.

Label Here

For the year Jan. 1–Dec. 31, 2006, or other tax year beginning , 2006, ending , 20 OMB No. 1545-0074 Your first name and initial Last name Your social security number If a joint return, spouse's first name and initial Last name Spouse's social security number Home address (number and street). If you have a P.O. box, see page 16. Apt. no. City, town or post office, state, and ZIP code. If you have a foreign address, see page 16. You must enter your SSN(s) above. Checking a box below will not change your tax or refund.

Presidential Election Campaign Check here if you, or your spouse if filing jointly, want \$3 to go to this fund (see page 16) You Spouse

Filing Status

Check only one box.

- 1 Single 2 Married filing jointly (even if only one had income) 3 Married filing separately. Enter spouse's SSN above and full name here. 4 Head of household (with qualifying person). (See page 17.) If the qualifying person is a child but not your dependent, enter this child's name here. 5 Qualifying widow(er) with dependent child (see page 17)

Exemptions

If more than four dependents, see page 19.

6a Yourself. If someone can claim you as a dependent, do not check box 6a 6b Spouse 6c Dependents: (1) First name Last name (2) Dependent's social security number (3) Dependent's relationship to you (4) if qualifying child for child tax credit (see page 19) 6d Total number of exemptions claimed Boxes checked on 6a and 6b No. of children on 6c who: lived with you did not live with you due to divorce or separation (see page 20) Dependents on 6c not entered above Add numbers on lines above

Income

Attach Form(s) W-2 here. Also attach Forms W-2G and 1099-R if tax was withheld.

If you did not get a W-2, see page 23.

Enclose, but do not attach, any payment. Also, please use Form 1040-V.

7 Wages, salaries, tips, etc. Attach Form(s) W-2 7 8a Taxable interest. Attach Schedule B if required 8a 8b Tax-exempt interest. Do not include on line 8a 8b 9a Ordinary dividends. Attach Schedule B if required 9a 9b Qualified dividends (see page 23) 9b 10 Taxable refunds, credits, or offsets of state and local income taxes (see page 24) 10 11 Alimony received 11 12 Business income or (loss). Attach Schedule C or C-EZ 12 13 Capital gain or (loss). Attach Schedule D if required. If not required, check here 13 14 Other gains or (losses). Attach Form 4797 14 15a IRA distributions 15a b Taxable amount (see page 25) 15b 16a Pensions and annuities 16a b Taxable amount (see page 26) 16b 17 Rental real estate, royalties, partnerships, S corporations, trusts, etc. Attach Schedule E 17 18 Farm income or (loss). Attach Schedule F 18 19 Unemployment compensation 19 20a Social security benefits 20a b Taxable amount (see page 27) 20b 21 Other income. List type and amount (see page 29) 21 22 Add the amounts in the far right column for lines 7 through 21. This is your total income 22

Adjusted Gross Income

23 Archer MSA deduction. Attach Form 8853 23 24 Certain business expenses of reservists, performing artists, and fee-basis government officials. Attach Form 2106 or 2106-EZ 24 25 Health savings account deduction. Attach Form 8889 25 26 Moving expenses. Attach Form 3903 26 27 One-half of self-employment tax. Attach Schedule SE 27 28 Self-employed SEP, SIMPLE, and qualified plans 28 29 Self-employed health insurance deduction (see page 29) 29 30 Penalty on early withdrawal of savings 30 31a Alimony paid b Recipient's SSN 31a 32 IRA deduction (see page 31) 32 33 Student loan interest deduction (see page 33) 33 34 Jury duty pay you gave to your employer 34 35 Domestic production activities deduction. Attach Form 8903 35 36 Add lines 23 through 31a and 32 through 35 36 37 Subtract line 36 from line 22. This is your adjusted gross income 37

Tax and Credits

Standard Deduction for—

- People who checked any box on line 39a or 39b or who can be claimed as a dependent, see page 34.
- All others:
 - Single or Married filing separately, \$5,150
 - Married filing jointly or Qualifying widow(er), \$10,300
 - Head of household, \$7,550

38	Amount from line 37 (adjusted gross income)	38	
39a	Check <input type="checkbox"/> You were born before January 2, 1942, <input type="checkbox"/> Blind. <input type="checkbox"/> Spouse was born before January 2, 1942, <input type="checkbox"/> Blind. Total boxes checked 39a		
b	If your spouse itemizes on a separate return or you were a dual-status alien, see page 34 and check here 39b		
40	Itemized deductions (from Schedule A) or your standard deduction (see left margin)	40	
41	Subtract line 40 from line 38	41	
42	If line 38 is over \$112,875, or you provided housing to a person displaced by Hurricane Katrina, see page 36. Otherwise, multiply \$3,300 by the total number of exemptions claimed on line 6d	42	
43	Taxable income. Subtract line 42 from line 41. If line 42 is more than line 41, enter -0-	43	
44	Tax (see page 36). Check if any tax is from: a <input type="checkbox"/> Form(s) 8814 b <input type="checkbox"/> Form 4972	44	
45	Alternative minimum tax (see page 39). Attach Form 6251	45	
46	Add lines 44 and 45	46	
47	Foreign tax credit. Attach Form 1116 if required	47	
48	Credit for child and dependent care expenses. Attach Form 2441	48	
49	Credit for the elderly or the disabled. Attach Schedule R	49	
50	Education credits. Attach Form 8863	50	
51	Retirement savings contributions credit. Attach Form 8880	51	
52	Residential energy credits. Attach Form 5695	52	
53	Child tax credit (see page 42). Attach Form 8901 if required	53	
54	Credits from: a <input type="checkbox"/> Form 8396 b <input type="checkbox"/> Form 8839 c <input type="checkbox"/> Form 8859	54	
55	Other credits: a <input type="checkbox"/> Form 3800 b <input type="checkbox"/> Form 8801 c <input type="checkbox"/> Form	55	
56	Add lines 47 through 55. These are your total credits	56	
57	Subtract line 56 from line 46. If line 56 is more than line 46, enter -0-	57	

Other Taxes

58	Self-employment tax. Attach Schedule SE	58	
59	Social security and Medicare tax on tip income not reported to employer. Attach Form 4137	59	
60	Additional tax on IRAs, other qualified retirement plans, etc. Attach Form 5329 if required	60	
61	Advance earned income credit payments from Form(s) W-2, box 9	61	
62	Household employment taxes. Attach Schedule H	62	
63	Add lines 57 through 62. This is your total tax	63	

Payments

If you have a qualifying child, attach Schedule EIC.

64	Federal income tax withheld from Forms W-2 and 1099	64	
65	2006 estimated tax payments and amount applied from 2005 return	65	
66a	Earned income credit (EIC)	66a	
b	Nontaxable combat pay election 66b		
67	Excess social security and tier 1 RRTA tax withheld (see page 60)	67	
68	Additional child tax credit. Attach Form 8812	68	
69	Amount paid with request for extension to file (see page 60)	69	
70	Payments from: a <input type="checkbox"/> Form 2439 b <input type="checkbox"/> Form 4136 c <input type="checkbox"/> Form 8885	70	
71	Credit for federal telephone excise tax paid. Attach Form 8913 if required	71	
72	Add lines 64, 65, 66a, and 67 through 71. These are your total payments	72	

Refund

Direct deposit? See page 61 and fill in 74b, 74c, and 74d, or Form 8888.

73	If line 72 is more than line 63, subtract line 63 from line 72. This is the amount you overpaid	73	
74a	Amount of line 73 you want refunded to you . If Form 8888 is attached, check here <input type="checkbox"/>	74a	
b	Routing number <input type="text"/>	c	Type: <input type="checkbox"/> Checking <input type="checkbox"/> Savings
d	Account number <input type="text"/>		
75	Amount of line 73 you want applied to your 2007 estimated tax	75	
76	Amount of line 73 you want applied to your 2007 estimated tax	76	

Amount You Owe

76	Amount you owe. Subtract line 72 from line 63. For details on how to pay, see page 62	76	
77	Estimated tax penalty (see page 62)	77	

Third Party Designee

Do you want to allow another person to discuss this return with the IRS (see page 63)? **Yes.** Complete the following. **No**

Designee's name <input type="text"/>	Phone no. <input type="text"/> (<input type="text"/>) <input type="text"/>	Personal identification number (PIN) <input type="text"/>
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Sign Here

Under penalties of perjury, I declare that I have examined this return and accompanying schedules and statements, and to the best of my knowledge and belief, they are true, correct, and complete. Declaration of preparer (other than taxpayer) is based on all information of which preparer has any knowledge.

Joint return? See page 17. Keep a copy for your records.

Your signature <input type="text"/>	Date <input type="text"/>	Your occupation <input type="text"/>	Daytime phone number (<input type="text"/>) <input type="text"/>
Spouse's signature. If a joint return, both must sign. <input type="text"/>	Date <input type="text"/>	Spouse's occupation <input type="text"/>	<input type="text"/>

Paid Preparer's Use Only

Preparer's signature <input type="text"/>	Date <input type="text"/>	Check if self-employed <input type="checkbox"/>	Preparer's SSN or PTIN <input type="text"/>
Firm's name (or yours if self-employed), address, and ZIP code <input type="text"/>	EIN <input type="text"/>	Phone no. (<input type="text"/>) <input type="text"/>	

Table 473. Federal Individual Income Tax Returns With Adjusted Gross Income (AGI)—Summary: 2000 and 2003

[129,374 represents 129,374,000. Includes Puerto Rico and Virgin Islands. Includes returns of resident aliens, based on a sample of unaudited returns as filed. Data are not comparable for all years because of tax changes and other changes. See *Statistics of Income, Individual Income Tax Returns* publications for a detailed explanation. See Appendix III]

Item	Number of returns (1,000)		Amount (mil. dol.)		Average amount (dollars)	
	2000	2003	2000	2003	2000	2003
Total returns	129,374	130,424	6,365,377	6,207,109	49,201	47,592
Adjusted gross income (AGI)	129,374	130,424	6,365,377	6,207,109	49,201	47,592
Salaries and wages	110,169	110,890	4,456,167	4,649,900	40,448	41,933
Taxable interest received	68,046	59,459	199,322	127,160	2,929	2,139
Tax-exempt interest	4,658	4,525	53,952	53,750	11,583	11,878
Dividends in AGI	34,141	30,475	146,988	115,141	4,305	3,778
Business or profession net income	13,313	14,442	244,598	268,582	18,373	18,597
Business or profession net loss	4,287	4,973	30,733	38,527	7,169	7,747
Net capital gain in AGI	22,646	9,081	644,285	322,974	28,450	35,566
Net capital loss in AGI	6,875	12,808	13,742	28,952	1,999	2,260
Sales of property other than capital assets, net gain	827	799	7,445	8,139	9,002	10,186
Sales of property other than capital assets, net loss	873	955	8,364	8,469	9,581	8,868
Pensions and annuities in AGI	21,765	22,823	325,828	372,931	14,970	16,340
Unemployment compensation in AGI	6,478	10,065	16,913	44,036	2,611	4,375
Social security benefits in AGI	10,609	10,975	89,964	97,707	8,480	8,903
Rent net income	4,201	4,086	45,099	49,236	10,735	12,050
Rent net loss	4,520	4,529	30,309	37,558	6,706	8,293
Royalty net income	1,104	1,243	7,998	10,730	7,245	8,632
Royalty net loss	36	33	101	124	2,806	3,758
Partnerships and S Corporations net income ¹	4,180	4,454	285,425	333,029	68,283	74,771
Partnerships and S Corporations net loss ¹	2,121	2,553	72,511	78,972	34,187	30,933
Estate or trust net income	557	499	12,134	13,499	21,785	27,052
Estate or trust net loss	39	33	1,128	1,084	28,923	32,848
Farm net income	703	592	8,270	7,473	11,764	12,623
Farm net loss	1,359	1,405	17,305	19,844	12,734	14,124
Statutory adjustments, total ²	23,197	30,382	58,610	87,576	2,527	2,882
Educator expenses (X)	(X)	3,241	(X)	806	(X)	249
Individual retirement arrangements	3,505	3,418	7,477	10,006	2,133	2,927
Student loan interest deduction	4,478	6,953	2,639	4,410	589	634
Tuition and fees deduction	(X)	3,571	(X)	6,684	(X)	1,872
Medical savings accounts	65	67	120	129	1,846	1,925
Deduction for self-employment tax	14,300	15,373	17,393	19,791	1,216	1,287
Self-employment health insurance	3,565	3,802	7,569	16,454	2,123	4,328
Keogh and self-employed retirement plans	1,288	1,209	12,475	17,796	9,686	14,720
Exemptions, total ³	252,332	261,126	690,109	781,305	2,735	2,992
Deductions, total	128,205	128,593	1,293,181	1,457,645	10,087	11,335
Standard deductions	85,671	84,643	470,821	539,921	5,496	6,379
Returns with additional standard deductions for age 65 or older or for blindness	11,331	11,201	14,736	15,859	1,301	1,416
Itemized deductions, total ²	42,534	43,950	822,361	901,865	19,334	20,520
Medical and dental expenses	6,513	8,678	39,251	56,007	6,027	6,454
Taxes paid	41,824	43,062	294,712	310,897	7,046	7,220
Interest paid	35,405	36,212	322,932	340,319	9,121	9,398
Home mortgage interest paid	34,914	35,797	299,963	325,192	8,591	9,084
Charitable contributions	37,525	38,627	140,682	145,702	3,749	3,772
Taxable income	105,259	101,393	4,544,242	4,200,218	43,172	41,425
Income tax before credits	105,278	101,413	1,018,219	790,006	9,672	7,790
Tax credits, total ²	37,736	39,247	37,722	41,069	1,000	1,046
Child care credit	6,368	6,313	2,794	3,207	439	508
Elderly and disabled credit	156	123	33	20	212	163
Child tax credit	26,405	25,672	19,689	22,788	746	888
Education credit	6,815	7,298	4,851	5,843	712	801
Retirement savings contributions	(X)	5,297	(X)	1,034	X	195
Foreign tax credit	3,936	4,145	5,990	5,806	1,522	1,401
General business credit	275	263	764	613	2,778	2,331
Income tax after credits	96,816	88,922	980,497	748,010	10,127	8,412
Income tax, total	96,818	88,922	980,645	748,017	10,129	8,412
Alternative minimum tax	1,304	2,358	9,601	9,470	7,363	4,016
Earned income credit	19,277	22,024	32,296	38,657	1,675	1,755
Used to offset income tax before credits	5,416	3,606	1,969	926	364	257
Used to offset other taxes	3,148	4,401	2,524	3,718	802	845
Excess earned income credit (refundable)	16,126	19,162	27,804	34,012	1,724	1,775
Tax payments, total	122,244	123,462	1,084,868	974,543	8,875	7,893
Income tax withheld	113,733	114,862	763,901	703,758	6,717	6,127
Excess social security tax withheld	1,641	1,121	2,185	1,566	1,332	1,397
Estimated tax payments	13,327	11,576	221,622	182,907	16,630	15,801
Payments with requests for extension of filing time	1,611	1,334	63,397	38,303	39,353	28,713
Taxes due at time of filing	30,624	21,072	134,944	73,741	4,406	3,499
Tax overpayments, total	95,921	105,362	196,199	254,554	2,045	2,416
Overpayment refunds	93,000	102,005	167,577	219,752	1,802	2,154

X Not applicable. ¹ S Corporations are certain small corporations with up to 35 shareholders. ² Includes items not shown separately. ³ Total exemptions amount is after limitation.

Source: U.S. Internal Revenue Service, *Statistics of Income Bulletin*, quarterly, and *Statistics of Income, Individual Income Tax Returns*, annual.

Table 470. Internal Revenue Gross Collections by Type of Tax: 2001 to 2005

[2,129 represents \$2,129,000,000,000. For fiscal year ending in year shown; see text, Section 8. See also text, this section for information on taxes]

Type of tax	Gross collection (bil. dol.)					Percent of total				
	2001	2002	2003	2004	2005	2001	2002	2003	2004	2005
United States, total	2,129	2,017	1,953	2,019	2,269	100.0	100.0	100.0	100.0	100.0
Individual income taxes	1,178	1,038	987	990	1,108	55.3	51.5	50.5	49.1	48.8
Withheld by employers	795	751	735	747	787	37.3	37.2	37.6	37.0	34.7
Employment taxes ¹	682	688	696	717	771	32.0	34.1	35.6	35.5	34.0
Old-age and disability insurance	670	677	685	706	760	31.5	33.6	35.1	35.0	33.5
Unemployment insurance	7	7	7	7	7	0.3	0.3	0.3	0.3	0.3
Corporation income taxes	187	211	194	231	307	8.8	10.5	9.9	11.4	13.5
Estate and gift taxes	29	27	23	26	26	1.4	1.4	1.2	1.3	1.1
Excise taxes	52	52	53	55	57	2.5	2.6	2.7	2.7	2.5

¹ Includes railroad retirement tax, not shown separately.

Source: U.S. Internal Revenue Service, *IRS Data Book*, annual, Publication 55B. See Internet site <<http://www.irs.gov/taxstats/article/0,,id=102174,00.html>>.

Table 471. Taxable Returns Filed—Examination Coverage: 2005

[130,577 represents 130,577,000. See the annual *IRS Data Book* (Publication 55B) for a detailed explanation]

Type and size of return	Returns filed ¹ (1,000)	Returns examined		Total recommended additional tax (\$1,000)	Average recommended additional tax per return (dollars)
		Total ² (1,000)	Percent coverage		
Individual returns, total	130,577	1,215	0.93	13,365,587	10,998
Nonbusiness returns:					
Form 1040A, with TPI under \$25,000 ³	32,913	170	0.52	413,712	2,429
All other returns by size of TPI ⁴ :					
Under \$25,000	19,795	292	1.48	1,019,639	3,492
\$25,000 under \$50,000	30,870	186	0.60	1,171,130	6,298
\$50,000 under \$100,000	25,746	146	0.57	431,144	2,960
\$100,000 or more	11,562	138	1.19	7,371,402	53,383
Business returns:					
Schedule C returns by size of TGR ⁴ :					
Under \$25,000	3,204	118	3.68	273,794	2,320
\$25,000 under \$100,000	3,742	83	2.21	594,874	7,207
\$100,000 and more	2,149	78	3.65	2,042,322	26,018
Schedule F returns by size of TGR ⁴ :					
Under \$100,000	337	2	0.48	3,248	2,026
\$100,000 or more	259	3	1.01	44,322	16,878
Corporation (except S corporation)	2,329	29	1.24	32,216,498	1,111,757
Fiduciary	3,722	7	0.18	307,010	46,580
Estate	74	6	8.20	970,096	159,529
Gift	262	2	0.81	670,901	315,718
Employment	30,494	34	0.11	756,562	22,418
Excise	835	17	1.98	140,355	8,474
Other taxable returns	(NA)	(Z)	(NA)	195,789	475,216

NA Not available. Z Less than 500.

¹ Returns filed in previous calendar year. ² Includes taxpayer examinations by correspondence and activities to protect release of funds from the U.S. Treasury in response to taxpayer efforts to recoup tax previously assessed and paid. ³ TPI = Total positive income, i.e., excludes losses. ⁴ TGR = Total gross receipts.

Source: U.S. Internal Revenue Service, *IRS Data Book*, annual, Publication 55B. See Internet site <<http://www.irs.gov/taxstats/article/0,,id=102174,00.html>>.

Table 472. Individual Income Tax Returns Filed—Examination Coverage: 1990 to 2005

[109,868 represents 109,868,000. See the annual *IRS Data Book* (Publication 55B) for a detailed explanation]

Year	Returns filed ¹ (1,000)	Returns examined		Total recommended additional tax ³ (\$1,000)	Average recommended additional tax per return (dollars) ³
		Total ² (1,000)	Percent coverage		
1990	109,868	1,145	1.04	5,336,063	4,660
1995	114,683	1,919	1.67	7,756,954	4,041
1996	116,060	1,942	1.67	7,600,191	3,915
1997	118,363	1,519	1.28	8,363,918	5,505
1998	120,342	1,193	0.99	6,095,698	5,110
1999	122,547	1,100	0.90	4,458,474	4,052
2000	124,887	618	0.49	3,388,905	5,486
2001	127,097	732	0.58	3,301,860	4,512
2003	130,341	849	0.65	4,559,902	5,369
2004	130,134	1,008	0.77	6,203,236	6,155
2005	130,577	1,215	0.93	13,365,587	10,998

¹ Returns filed in previous calendar year. ² Includes taxpayer examinations by correspondence and activities to protect release of funds from the U.S. Treasury in response to taxpayer efforts to recoup tax previously assessed and paid. ³ For 1990–1997, amount includes associated penalties.

Source: U.S. Internal Revenue Service, *IRS Data Book*, annual, Publication 55B. See Internet site <<http://www.irs.gov/taxstats/article/0,,id=102174,00.html>>.

2006 Tax Rate Schedules



The Tax Rate Schedules are shown so you can see the tax rate that applies to all levels of taxable income. Do not use them to figure your tax. Instead, see the instructions for line 44 that begin on page 36.

Schedule X—If your filing status is **Single**

If your taxable income is:		The tax is:	
Over—	But not over—		of the amount over—
\$0	\$7,550	10%	\$0
7,550	30,650	\$755.00 + 15%	7,550
30,650	74,200	4,220.00 + 25%	30,650
74,200	154,800	15,107.50 + 28%	74,200
154,800	336,550	37,675.50 + 33%	154,800
336,550	.....	97,653.00 + 35%	336,550

Schedule Y-1—If your filing status is **Married filing jointly** or **Qualifying widow(er)**

If your taxable income is:		The tax is:	
Over—	But not over—		of the amount over—
\$0	\$15,100	10%	\$0
15,100	61,300	\$1,510.00 + 15%	15,100
61,300	123,700	8,440.00 + 25%	61,300
123,700	188,450	24,040.00 + 28%	123,700
188,450	336,550	42,170.00 + 33%	188,450
336,550	.....	91,043.00 + 35%	336,550

Schedule Y-2—If your filing status is **Married filing separately**

If your taxable income is:		The tax is:	
Over—	But not over—		of the amount over—
\$0	\$7,550	10%	\$0
7,550	30,650	\$755.00 + 15%	7,550
30,650	61,850	4,220.00 + 25%	30,650
61,850	94,225	12,020.00 + 28%	61,850
94,225	168,275	21,085.00 + 33%	94,225
168,275	.....	45,521.50 + 35%	168,275

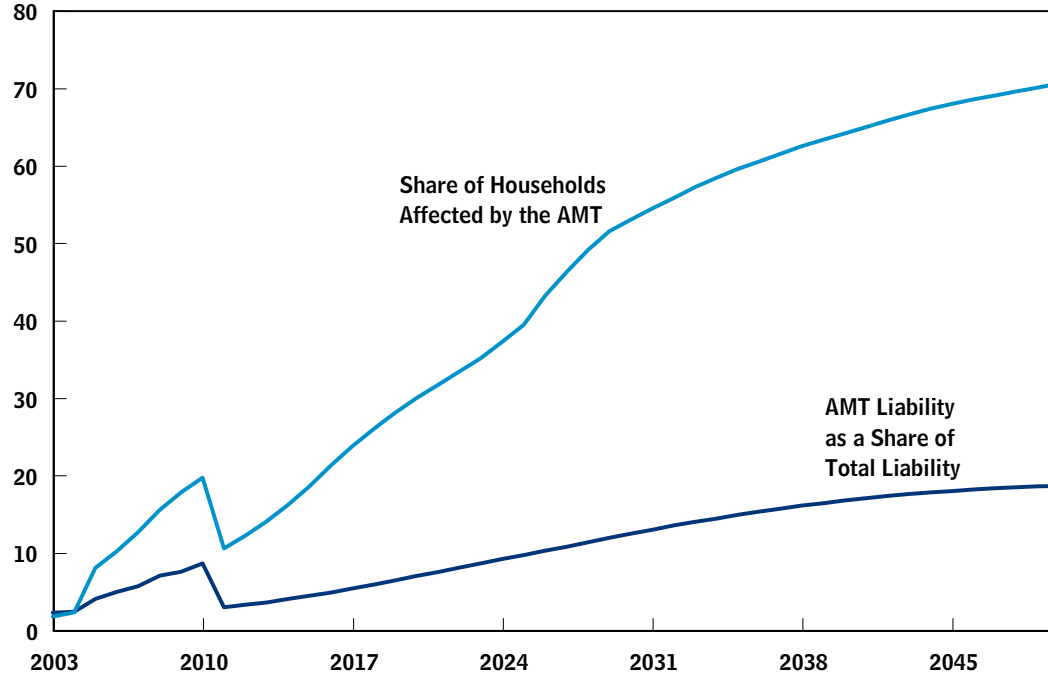
Schedule Z—If your filing status is **Head of household**

If your taxable income is:		The tax is:	
Over—	But not over—		of the amount over—
\$0	\$10,750	10%	\$0
10,750	41,050	\$1,075.00 + 15%	10,750
41,050	106,000	5,620.00 + 25%	41,050
106,000	171,650	21,857.50 + 28%	106,000
171,650	336,550	40,239.50 + 33%	171,650
336,550	.....	94,656.50 + 35%	336,550

Figure 2.

The AMT's Impact on Individual Income Tax Liabilities Under Current Law, 2003 to 2050

(Percent)



Source: Congressional Budget Office.

Note: AMT = alternative minimum tax.

those tax law changes is illustrated by the expected drop after 2010 in the number of taxpayers that the AMT affects (see Figure 1). That number falls from about 30 million to 16 million between 2010 and 2011, when the 2001 changes are scheduled to expire, and then begins to increase again after 2011 as a result of inflation.

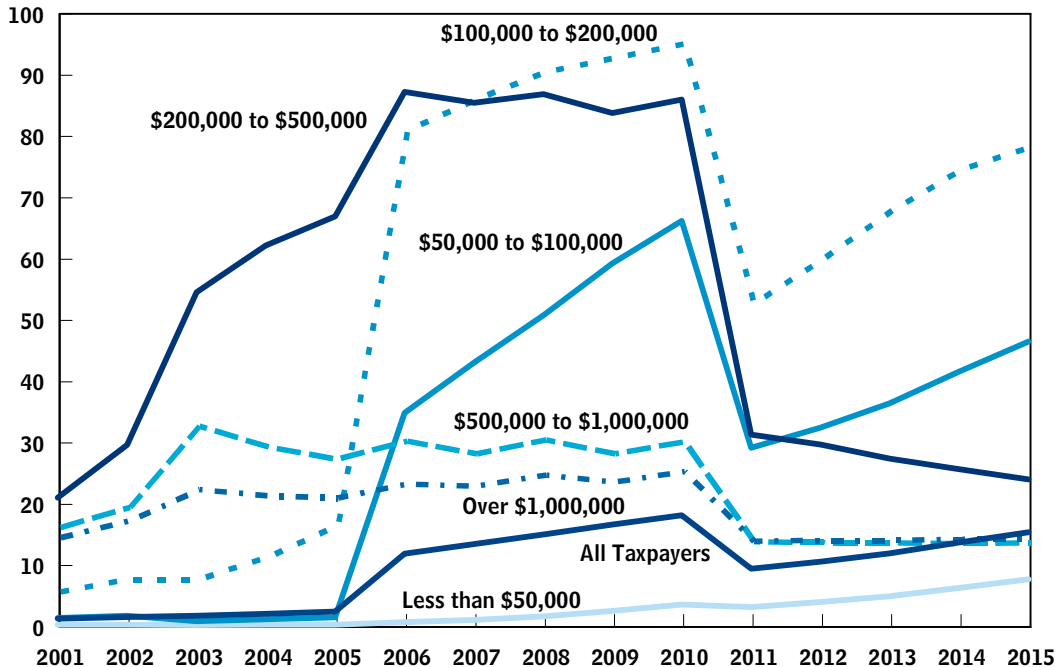
Who Is Affected by the AMT?

The types of taxpayers who are affected by the AMT are changing over time. Historically, many of those subject to it were the relatively small number of filers who used a narrow set of tax preferences that were not allowed under the alternative tax. (For example, relatively few taxpayers are eligible for incentive stock options, which receive less favorable treatment under the AMT than under the regular income tax.) In the years to come, however, the preferences that are not allowed under the AMT and that will move taxpayers within its sphere are some of the more widely used features of the regular tax, such as the personal exemption (which is used by all taxpayers) and the standard deduction (which is

Figure 4.

Taxpayers with AMT Liability, by Adjusted Gross Income in 2005 Dollars, Calendar Years 2001 to 2014

(Percentage of taxpayers)



Source: Congressional Budget Office.

Note: AMT = alternative minimum tax.

itemized; adjust for the phaseout, if it is applicable; compare the result with the appropriate standard deduction; and claim the larger of the two amounts. In calculating their tax liability under the AMT, taxpayers must make the same decision about deductions that they would make for the regular tax: whether to either itemize or claim the standard deduction. Taxpayers who claim the standard deduction under the regular tax cannot itemize their deductions under the AMT. However, because some itemized deductions may be claimed under the alternative tax, some taxpayers who are subject to it will have a smaller total tax liability if they claim itemized deductions that total less than their standard deduction. That factor increases to four the number of potential liabilities that a taxpayer must calculate to determine first, whether he or she is liable for the AMT, and second, how to pay the smallest amount of tax.

Much of the complexity created by the AMT can be lessened by using computer software to prepare tax-filing forms. Programs available on the Internet or for installation on individual computers automatically determine whether taxpayers have AMT liability and create the required paperwork. But not all taxpayers have

Table 1.**How the AMT Options Affect Revenues and Taxpayers**

	Reduced Receipts, Fiscal Years 2006 to 2015^a (Billions of dollars)	Number of Taxpayers Subject to the AMT in 2010^b (Millions)
Repeal the AMT	611	0
Extend the 2005 Exemption to 2006 and Index All Parameters Thereafter	385	7
Allow Personal Exemptions Under the AMT	343	11
Allow State and Local Tax Deductions Under the AMT	423	17
Allow the Standard Deduction Under the AMT	64	23

Sources: Congressional Budget Office; Joint Committee on Taxation.

a. The effective date for the options is assumed to be January 2006.

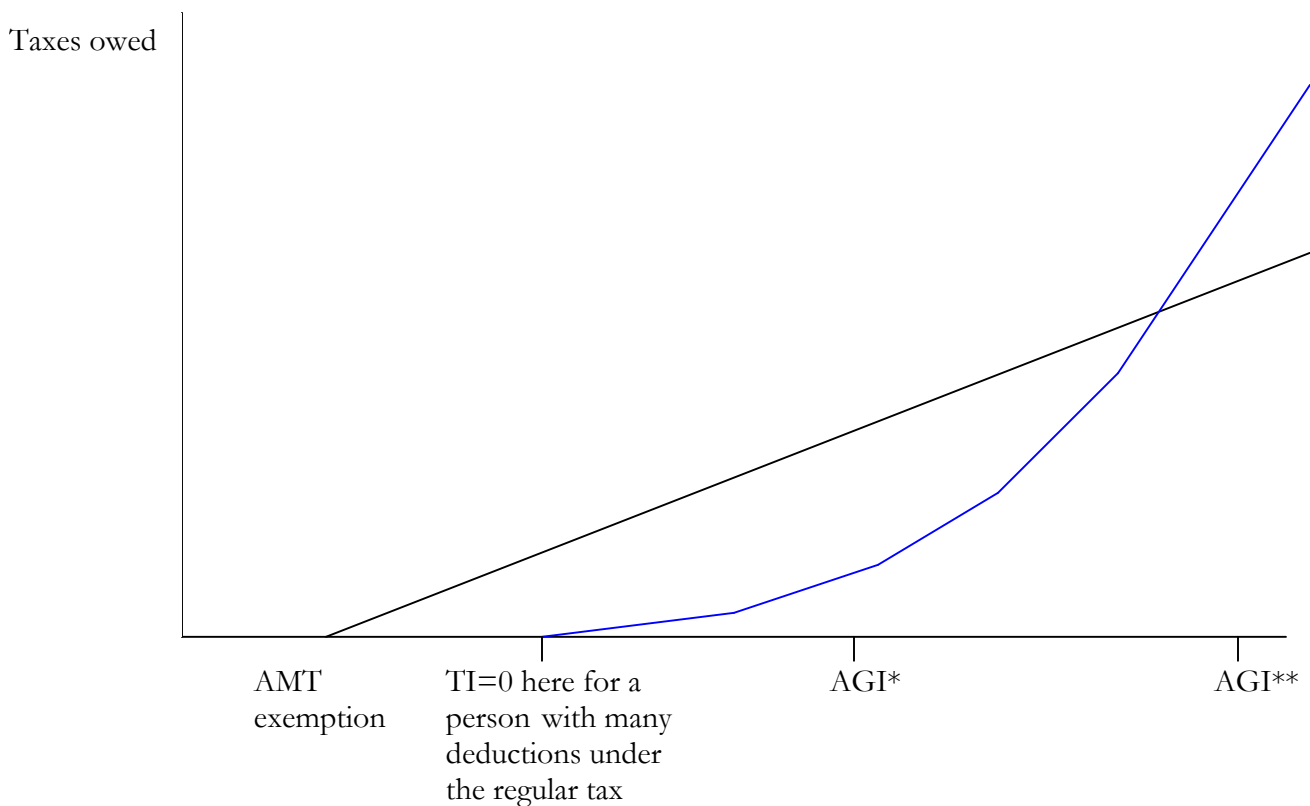
b. The number of taxpayers subject to the AMT in 2010 under current law is 29 million.

Another alternative for mitigating the impact of the AMT would be to allow certain preferences under it that are expected to affect a growing number of taxpayers. Permitting the same personal and dependent exemptions under the AMT as under the regular income tax would remove about 18 million tax units from the AMT's reach in 2010, or more than 60 percent of all taxpayers who would owe the alternative tax under current law in that year. The option would reduce federal revenues by about \$343 billion between 2006 and 2015.

Alternatively, allowing taxpayers to deduct state and local taxes for the purposes of the AMT would eliminate its impact for about 12 million taxpayers in 2010 (roughly 40 percent of those who would pay the tax in that year under current law) and reduce federal revenues by about \$423 billion during the 2006-2015 period.

Allowing the standard deduction under the AMT would have the smallest effect on revenues of any option discussed here other than the one-year extension of the higher exemption amount. If the standard deduction was allowed, revenues would be reduced by about \$64 billion between 2006 and 2015, and the AMT's effect would be eliminated for 6 million taxpayers in 2010.

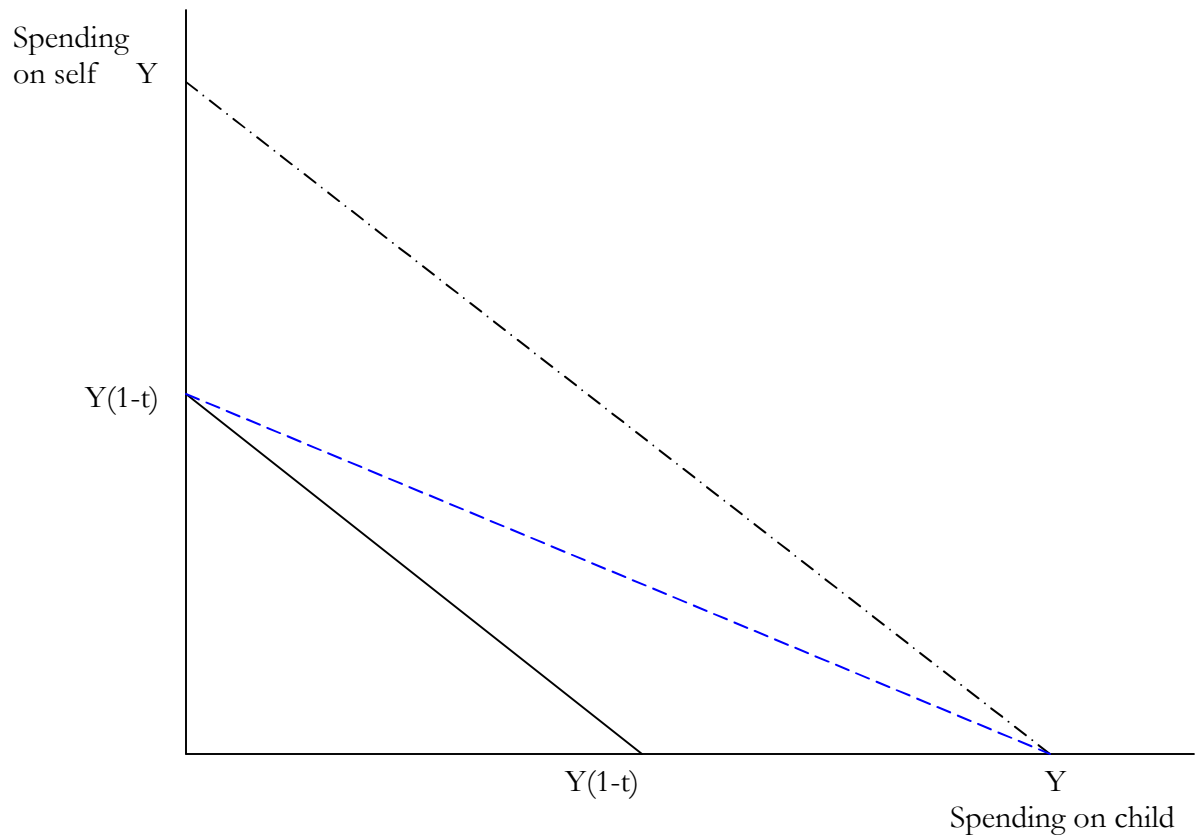
Tax liability under the AMT and under the regular income tax. You owe the higher of the two.



Consider two people, both of whom have many deductions under the regular tax. One person has income equal to AGI^* and the other has income AGI^{**} . The person with income AGI^* owes more tax under the AMT than under the regular tax, so he pays the AMT. The person with income AGI^{**} owes more regular tax than AMT, so he pays the regular tax.

The picture is approximate. The AMT exemption in 2005 was \$58,000 for a married couple filing jointly. The basic AMT tax rate was 26%. The details are really more complicated than this because the exemption phases out at high incomes and there is also a 28% rate. The basic idea conveyed by the picture, however, is correct.

Incentive effects of tax deductions.



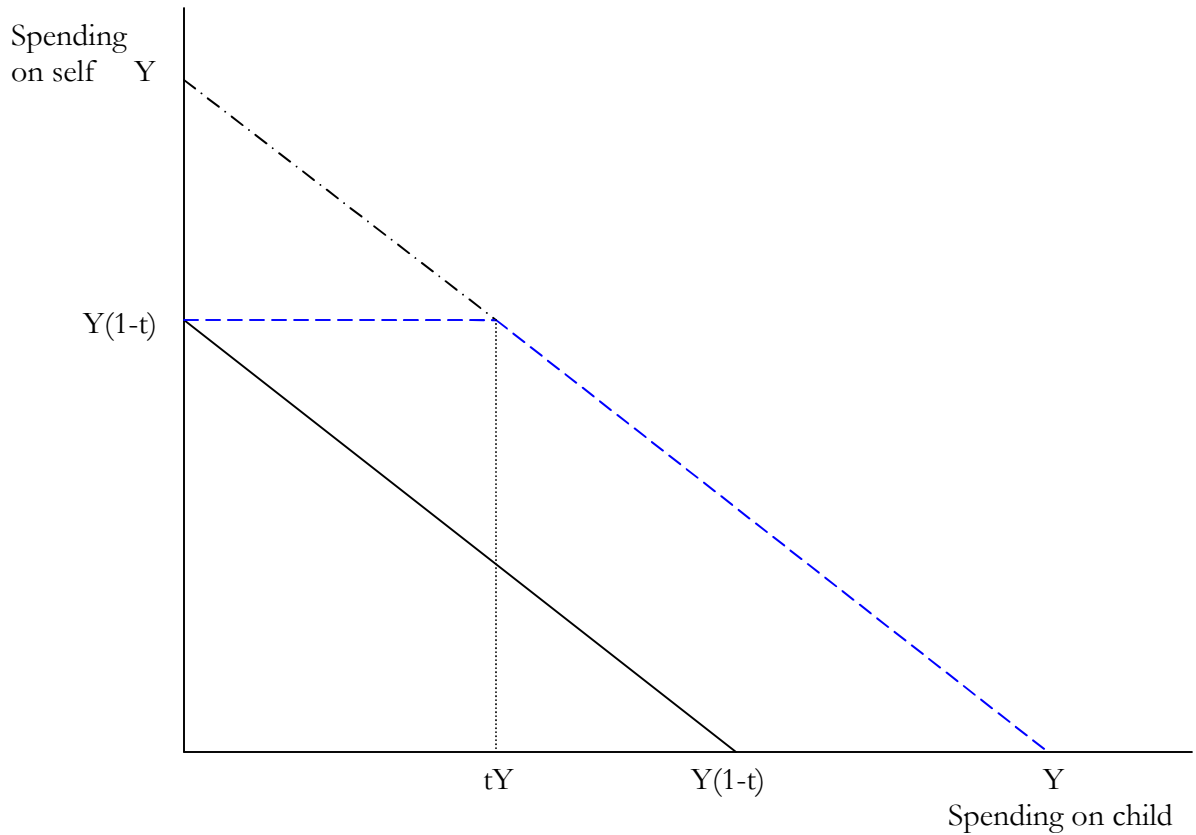
Assume taxes exist ($t > 0$) but there are no deductions or credits. The budget constraint is the solid line connecting $Y(1-t)$ on both axes.

Now introduce a tax deduction for spending on your child. The budget constraint is now the line of all dashes connecting $Y(1-t)$ and Y . It now costs only $1-t$ cents to spend a dollar on your child. The value of the deduction is worth more to you the higher the tax rate (or your tax bracket).

In terms of before-tax income, I need to earn an extra \$1 to spend an extra dollar on my child. I need to earn an extra $1/(1-t)$ dollars to spend an extra dollar on myself, since net of tax this is $(1-t)/(1-t) = \$1$.

[Of course, before-tax income isn't really exogenous; at the very least you work and earn a wage. To capture this, we really need to define preferences over leisure time, spending on self and spending on child, and then have a budget constraint defined over all three.]

Incentive effects of nonrefundable tax credits.



Assume taxes exist ($t > 0$) but there are no deductions or credits. The budget constraint is the solid line connecting $Y(1-t)$ on both axes.

Now introduce a nonrefundable tax credit for spending on your child. The budget constraint is now the kinked line of all dashes. It costs you nothing to spend up to tY on your child. Your tax liability falls dollar-for-dollar as your spending on your child increases. Once you have eliminated all of your tax liability, it costs you \$1 of after-tax income to spend an additional dollar on your child.