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President's Tax Panel May Have Costly Plan for the City

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The Alternative Minimum Tax Takes a Rising Toll on the City

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THE PRESIDENT'S ADVISORY PANEL ON FEDERAL TAX REFORM, which is expected to issue its recommendations next week, will reportedly suggest eliminating the alternative minimum tax (AMT), among many other reforms. This would be welcome news for many New Yorkers and residents of other high-tax areas, for whom the AMT has become an unexpected burden.

But the cost to the federal government of eliminating the AMT is already very high and expected to mushroom in the coming years—from $21 billion for the current tax year to $110 billion by 2010, according to recent estimates of the Joint Committee on Taxation. To make up for the lost revenue and more generally restructure the tax system, the panel is expected to recommend a number of other sweeping reforms, such as reducing the number of tax brackets and eliminating most itemized deductions, including the deduction for state and local taxes.

IBO has projected the effects of ATM elimination and ending the state and local tax deduction, two reforms that would have especially large impacts on the federal tax burden of New Yorkers. By the end of the decade, eliminating both the AMT and the deductibility of state and local taxes would tend to shift the federal tax burden within the city from middle- and upper-middle income taxpayers to the most affluent. But by 2010 city taxpayers as a whole would send $1.4 billion more to Washington than under today's rules.

The number of New Yorkers whose federal taxes would decline slightly exceeds the number whose taxes would rise compared with projected taxes under current law. For city taxpayers as a whole, however, the total cost of loosing deductibility would far outweigh the total gain from not having to pay the AMT. Loosing deductibility would also make New York and other states and cities with high taxes more costly places to live by raising relative tax burdens, compared with low-tax areas.

AMT Growth in New York City. Originally established to ensure that the wealthiest Americans paid some income tax, the AMT is raising the federal tax burdens of increasing number of middle- and upper-middle income taxpayers, offsetting the benefits of recent tax cuts. (See IBO's April 2005 report, *The Alternative Minimum Tax Takes a Rising Toll on the City*.) The AMT has a disproportionate impact on taxpayers with children, married couples, and taxpayers residing in high-tax states and cities, like New York City. IBO estimates that 8 percent of all New York City taxpayers will incur individual AMT liability in 2005—New Yorkers are almost twice as likely to be affected by the tax as are U.S. taxpayers as a whole.

Federal AMT and Deductibility Reform: Impact on New Yorkers' Federal Tax Burdens in 2010

Federal Adjusted Gross Income (2005 dollars)	Number of taxpayers	Percent of taxpayers paying less	Average tax cut of taxpayers paying less	Percent of taxpayers paying more	Average tax increase of taxpayers paying more	Aggregate tax change for group ($millions)	Percent change in taxes
Eliminating the AMT							
Under $50,000	1,077,700	3.3%	($605)	0.0%	$ -	($21.4)	-2.2%
$50,000 to $250,000	1,104,900	61.0%	($3,172)	0.0%	$ -	($2,146.4)	-11.9%
$250,000 to $500,000	56,400	95.9%	($11,330)	0.0%	$ -	($613.8)	-11.8%
Over $500,000	35,400	37.9%	($20,678)	0.0%	$ -	($277.2)	-1.5%
All taxpayers	**2,274,400**	**34.2%**	**($3,925)**	**0.0%**	**$ -**	**($3,058.8)**	**-7.2%**
Eliminating Deductibility of State and Local Taxes							
Under $50,000	1,095,900	0.0%	$ -	11.6%	$466	$60.1	6.1%
$50,000 to $250,000	1,114,600	0.0%	$ -	33.1%	$1,109	$406.3	2.3%
$250,000 to $500,000	56,500	0.0%	$ -	53.4%	$5,905	$175.0	3.4%
Over $500,000	35,400	0.0%	$ -	95.5%	$61,955	$2,081.5	11.4%
All taxpayers	**2,302,400**	**0.0%**	**$ -**	**24.4%**	**$4,905**	**$2,722.8**	**6.4%**
Eliminating Both the AMT and Deductibility of State and Local Taxes							
Under $50,000	1,085,400	2.8%	($553)	11.6%	$465	$42.9	4.4%
$50,000 to $250,000	1,109,600	48.6%	($2,080)	32.8%	$1,108	($719.3)	-4.0%
$250,000 to $500,000	56,500	46.7%	($5,275)	53.2%	$5,914	$38.6	0.7%
Over $500,000	35,400	4.5%	($23,220)	95.5%	$61,938	$2,056.5	11.3%
All taxpayers	**2,286,900**	**26.1%**	**($2,198)**	**24.2%**	**$4,928**	**$1,418.7**	**3.3%**

SOURCES: IBO based on 2002 PIT Sample File, Office of Tax Policy Analysis, NYS Department of Taxation and Finance.
NOTES: Estimated impacts are relative to projected tax liabilities with no change in current law. Number of taxpayers exclude part-year residents and filers who do not owe any income tax—mostly households with incomes under $20,000. Because some filers may owe federal income tax under one option but not another, the number of taxpayers differs among three options. Under current law, there would be an estimated 2,292,345 taxpayers in 2010.

Barring changes in the law, the ranks of those paying the AMT will swell to a third of all city taxpayers by 2010, with middle- and upper-middle income taxpayers ($50,000 to $250,000) becoming far more likely to pay the AMT than those with incomes above $500,000. (Note: All 2010 income levels referred to in this report have been adjusted for predicted inflation to 2005 dollars.)

Two factors account for the rapidly rising number of New Yorkers who pay the AMT. First, the AMT has no inflation adjustments: brackets, exemptions, and other amounts are indexed in the regular tax but not for the AMT. Second, there were only temporary adjustments to the AMT when the 2001 and 2003 tax cuts made longer-lasting reductions in the regular income tax. By the end of the decade, city taxpayers will send an estimated $3 billion in additional tax payments to Washington, reducing local disposable income and spending in the city economy.

Eliminating the AMT and State and Local Deductibility. IBO has projected the impacts on New Yorkers' federal tax burdens of abolishing the AMT and eliminating the deductibility of state and local taxes, separately and in conjunction with one another. In order to reflect the expected surge in the coming years in the number of AMT-payers under current law, projections for 2010 were made.

Separate Impacts. As shown in the top section of the accompanying table, if the AMT were eliminated without any other federal tax reforms, by 2010 city taxpayers as a whole would pay $3.1 billion less in federal income taxes—7.2 percent less than they would pay under current law. Just over 70 percent of the tax cut would be received by taxpayers with incomes ranging from $50,000 to $250,000 in today's (2005) dollars, with six in ten of the taxpayers in this broad income group receiving a tax cut. Few taxpayers with incomes below $50,000 (3.3 percent) would be affected. A third of all taxpayers would receive a tax cut, averaging close to $4,000 among the group.

In contrast, eliminating state and local deductibility in and of itself would raise federal taxes for significant numbers of taxpayers in every income group, with high-income taxpayers most likely to be affected. As shown in the table, over half (53.4 percent) of those with income from $250,000 to $500,000 and almost all (95.5 percent) of those with incomes above $500,000 would pay more in taxes—83 percent of the total $2.7 billion increase in federal income taxes that New Yorkers would have to pay. For the highest income group, the tax increase would average almost $62,000 among those paying more, over 10 times as much as the average for any other income group.

About a third of taxpayers with incomes from $50,000 to $250,000 would be affected by eliminating deductibility, much less than the number in this range affected by AMT elimination, because under current law so many in this group are projected to become AMT-payers and thus unable to deduct state and local taxes.

Combined Impact. The projected impact from the combination of the two tax reforms is presented in the bottom section of the table. Those faring the worst under this scenario would be taxpayers with the highest incomes, who are less likely to pay the AMT and whose state and local deductions are highest. The vast majority—95.5 percent—of city taxpayers with incomes above $500,000 would pay more in federal taxes if the two changes were combined, while only 4.5 percent would pay less. As a group they would pay $2.1 billion more in federal taxes—an 11.3 percent tax hike.

Most taxpayers with incomes under $50,000—roughly 86 percent—would be unaffected by the elimination of either the AMT or itemized deductions for state and local taxes. Still, the group's federal income taxes as a whole would be 4.4 percent greater if both the AMT and deductibility were eliminated.

Almost all taxpayers with incomes between $250,000 and $500,000 either pay the AMT or itemize federal deductions, and those who would pay more in taxes with the combination of reforms (53.2 percent) only slightly outnumber those who would pay less (46.7 percent). On balance, the group as a whole would see their taxes increase by less than 1 percent.

The only income group whose taxes would be less than under current law if both the AMT and deductibility were eliminated is taxpayers with incomes from $50,000 to $250,000. These taxpayers as a group would pay $720 million (4.0 percent) less in federal taxes in 2010 than under current law, but the tax cut is much smaller than if only the AMT were eliminated. Still, more taxpayers in this group would receive a tax cut (48.6 percent), relative to current law, compared to 32.8 percent whose taxes would increase if the AMT and deductibility were both eliminated. Taxes would be reduced by an average of $2,080 for those paying less, while for those paying more, taxes would increase by $1,100 on average.

For all groups, the impacts of eliminating both the AMT and state and local deductibility are not simply the sum of the two separate impacts. Federal taxes are higher when both reforms are enacted than the sum of the separate impacts would indicate because fewer taxpayers would receive the benefits of abolishing the AMT. Eliminating the deductibility of state and local taxes would increase the "regular" (i.e., non-AMT) liabilities of many taxpayers by enough so that they no longer would incur the AMT. (See IBO's April 2005 report on the AMT for details.) With fewer AMT-payers, the aggregate benefits of AMT elimination are reduced. As shown in the table, only 26 percent of all taxpayers would see their taxes decline under the combination of reforms, compared with 34 percent when only the AMT is eliminated.

The Aggregate Cost to New York City. While the gains from AMT elimination for many New Yorkers will soon outweigh the costs of losing state and local deductibility, in the aggregate this mix of tax changes would be very costly for New York, even by the end of the decade when so many residents would become AMT-payers and therefore unable to take advantage of the deduction. By 2010, New Yorkers would pay a total of $1.4 billion (3.3 percent) more in federal tax, above what they would pay under current law. The resulting decline in disposable income of city residents would reduce local spending, and economic activity.

AMT Elimination and Competitiveness. The AMT has been allowed to expand far beyond its original role of ensuring that high-income households do not avoid their share of federal income taxes. New Yorkers are now twice as likely to pay the AMT as are taxpayers nationwide, due to our concentration of high-income residents and heavy state and local tax burdens. Over time, however, growing numbers of taxpayers across the U.S. will pay the AMT, and demand for elimination or sweeping reform of the AMT will become more widespread.

But offsetting the fiscal costs of doing away with the current AMT by eliminating state and local deductibility would be especially hard on New York City and other high-tax states and localities. If taxpayers are no longer able to offset a portion of their state and local taxes by a reduction in their federal taxes, it will become even more difficult for our high-tax jurisdiction to compete for residents and jobs.

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