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The Alternative Minimum Tax Takes a Growing Bite from the Big Apple
by Michael Jacobs

New York policymakers are rightly concerned about a proposal now being considered in Washington that would end taxpayers' ability to deduct state and local taxes from their federal income tax returns. But an existing federal tax—the alternative minimum tax—is already preventing many New Yorkers from taking these and other deductions and forcing them to shoulder a bigger tax burden.

Unless current tax law is changed, the number of local taxpayers who have to pay the AMT will mount rapidly. The consequences go beyond their own pocketbooks: an increasing share of disposable income will be shifted from the local economy to Washington and a growing number of New Yorkers will bear the full burden of the region's particularly high taxes, making it harder for us to compete with other localities for residents and jobs.

Taxpayers must pay the AMT if they owe more under its rules than under the "regular" tax system. Established over three decades ago to ensure that the most prosperous Americans do not escape income taxes by what was viewed as an unfair use of the tax law, over time the AMT has increased the tax burden on less affluent Americans. Using its simulation model and sample of New York City residents' tax returns, a recent report by the city's Independent Budget Office (http://www.ibo.nyc.ny.us/iboreports/AMTfbapr2005.pdf) found that the AMT is far more likely to burden upper-middle income and even middle-income city taxpayers than the most affluent. And if current tax law does not change, the incidence of the AMT will rise over the next few years, particularly among taxpayers with more modest incomes.

IBO estimates that about 136,000 city taxpayers are liable for the AMT for 2004, and the median amount of additional taxes owed by city taxpayers due to the AMT is $2,330. Because the AMT is not indexed for inflation, over time "bracket creep" will swell the number of New Yorkers paying the tax. By 2010 the number will rise to a projected 789,000—more than one-third of all city taxpayers.

For 2004, about 56 percent of New York City taxpayers with incomes between $125,000 and $500,000 are paying the AMT. But in the coming years an increasing number of taxpayers with lower incomes—from $50,000 to $125,000 a year controlling for inflation—will also have to pay the AMT. While roughly 4 percent of this latter income group is now liable for the AMT, over half this income group—479,000 taxpayers—will be subject to the tax by 2010. Unless the law is changed, this group will also become far more likely to pay the AMT than those with income above $500,000, only a third of who are expected to pay the AMT by 2010.

Taxpayers affected by the AMT cannot take many of the most common tax deductions, the largest of which is the deduction for state and local taxes. Because New York's state and local tax burden is unusually high, city taxpayers currently hit by the AMT far exceeds the comparable national estimate (6.7 percent v. 4.0 percent). AMT payers also cannot take the regular income tax exemption that rises with family size. As a result, the AMT particularly affects families with children—some 12 percent of such city taxpayers for 2004 and increasing fivefold to 64 percent for 2010.

Beyond increasing the tax burden on citizens who are not its intended targets, the AMT will cause New York City taxpayers to send an additional $12.9 billion to the federal government from 2004 to 2010, decreasing local disposable income and its economic stimulus. The AMT also makes it harder for the city to compete with more lightly taxed jurisdictions for residents and jobs because taxpayers subject to the alternative minimum tax cannot deduct this region's state and local taxes from their federal income taxes.

Moreover, because the tax affects New Yorkers disproportionately, compared to taxpayers elsewhere in the country, state and city residents are receiving less than they would otherwise get from the recent federal tax cuts—cuts which reduce the regular federal income tax but not AMT liabilities. The recent tax cuts in enacted in Washington have had paradoxical effects: by reducing regular federal income liabilities, the cuts shift many taxpayers into the ranks of those whose liabilities are determined by the AMT and thus neither enjoy the full benefit of the tax cuts nor receive the benefits of any possible future tax cuts. Given that a third of city taxpayers are projected to be AMT payers by 2010, making permanent the current tax cuts that are scheduled to expire in 2011 as proposed will not benefit many New Yorkers.

The alternative minimum tax is already a significant matter for many New York taxpayers. Fixing the problems with it needs to be part of the policy mix as Washington considers broader federal tax changes. For those concerned about state and local deductibility, the AMT give us a sense of what could be in store.

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