

NEWS AND ANALYSIS

ECONOMIC ANALYSIS

Growing AMT Pressures State and Local Governments

By Martin A. Sullivan — martysullivan@comcast.net

The good news: The value of your home has doubled in five years. The bad news: So have your property taxes. Well, at least those taxes are deductible against federal income tax, right?

Perhaps not. If you are one of the growing number of the upper middle class paying the individual alternative minimum tax, any increase in state and local income and property taxes will *not* reduce your federal taxes. The Reagan administration was able to persuade Congress to eliminate the deduction for state and local sales taxes, but not the deduction for state and local property and income taxes, as part of the reform of the *regular* income tax in 1986. However, the Tax Reform Act of 1986 eliminated the deduction for all state and local taxes for purposes of the individual AMT.

For almost two decades nobody much cared, because the AMT affected only a small number of upper-income taxpayers. But when the current version of the AMT became law in 1986, the exemption amount was not indexed for inflation. And because inflation has gradually eroded the value of the exemption, the number of AMT payers — just a few hundred thousand in the mid-1990s — has been growing at a geometric rate.

According to the Tax Policy Center, 2.6 million taxpayers paid AMT in 2002. Under current law, that number will increase to 18 million in 2010. If

Congress extends various temporary tax cuts, the number will be 36 million.

That 36 million would be about 24 percent of all tax return filers. The typical AMT payer is an upper-middle-class homeowner in a high-tax state with several children. (Personal exemptions are not allowed under the AMT.) Those are exactly the folks who currently account for the bulk of state and local tax deductions on federal tax returns. The table below shows that although they account for only 24 percent of tax return filers (if the tax cuts are extended), they would account for 69 percent of all state and local tax deductions.

In 1985 and 1986, a powerful coalition of wealthy individuals and politicians from high-tax states fought hard to retain the deduction for state and local income and property taxes. An elective alternative deduction for state and local sales taxes was added in 2004 but only for 2004 and 2005. As the AMT's reach grows, disgruntled taxpayers may start blaming their state and local governments, as well as the feds, for their predicament. If that happens, don't be surprised if you see popular state governors arousing their citizens to fight for repeal of the tax invented by nerdy guys with thick glasses and green eyeshades.

Notes

If a taxpayer is on the AMT, a marginal increase in state and local taxes will not be deductible, and the benefit of a marginal reduction will not be reduced by a loss of federal deductions. From that follows the increased pressure on state and local governments not to raise taxes and to cut taxes. It does not mean, however, that state and local tax (SALT) deductions provide no reduction at all in

Effect of AMT on State and Local Tax Deductions in 2010 (All dollar figures in millions unless otherwise noted.)					
Income Level (thousands of 2001 dollars)	Tax Reduction in 2001 Due to SALT Deduction	% of Filers on AMT		Tax Benefit Attributable to SALT Deductions No Longer Deductible by AMT Taxpayers	
		Without Extension of Tax Cuts	With Extension of Tax Cuts	Without Extension of Tax Cuts	With Extension of Tax Cuts
0-30	\$249	0.2	0.2	\$0	\$0
30-50	1,816	6.9	8.7	125	158
50-75	5,184	25.6	43.2	1,327	2,239
75-100	8,478	34.6	78.6	2,933	6,664
100-200	19,342	40.2	94.0	7,775	18,181
200-500	12,047	53.2	96.7	6,409	11,649
500-1,000	5,485	13.2	54.1	724	2,967
1,000	13,483	12.3	26.9	1,658	3,627
Total	\$66,084	—	—	\$20,951	\$45,485
AMT's Reduction of State and Local Tax Benefit →				32%	69%
Sources: Author's calculations, Urban Institute and Brookings Institution Tax Policy Center, Joint Committee on Taxation, and IRS. See notes at end of article. Note: SALT = state and local tax.					

federal income taxes. For example, if a taxpayer's SALT deduction were cut in half, he or she might no longer be on the AMT and the atrophied deduction would provide a reduction in regular income tax. The point here is that AMT payers don't use all of their SALT deduction.

The figures in the second column in the table are estimates from the Joint Committee on Taxation reported in "Estimates of Federal Tax Expenditures for Fiscal Years 2002-2006," Jan. 17, 2002, JCS-1-02, <http://www.house/jct.gov> (Doc 2002-1511 or 2002 TNT 13-12). The third and fourth columns are from Table 1 of Leonard E. Burman, William G. Gale, and Jeffrey Rohaly, "Policy Watch: The Expanding Reach of the Individual Alternative Minimum Tax," *Journal of Economic Perspectives*, 2003, p. 173. The fifth column is the product of columns two and three. The sixth column is the product of columns two and four. The JCT estimates shown in column 2 originally presented estimates for taxpayers with more than \$200,000 of income in a single total. Those were distributed into the three categories shown by using more detailed IRS data reported in David Campbell and Michael Parisi, "Individual Income Tax Returns, 2001," *SOI Bulletin*, Fall 2003, <http://www.irs.gov/taxstats>. None of these figures include the elective alternative deduction for state sales taxes enacted in 2004 for only 2004 and 2005. Only time will tell whether this deduction will be extended and raise benefit of SALT slightly in 2010.

Lawyers Discuss Postshelter Assault on Privilege

By Sheryl Stratton — ssratto@tax.org

Between the demands of the IRS and auditors, taxpayers are having to work hard to maintain privilege over tax advice, panelists agreed during a teleconference last week cosponsored by the American Bar Association Section of Taxation and Continuing Legal Education Division.

Despite a recent court decision upholding application of the federally authorized tax practitioner privilege, former IRS Chief Counsel B. John Williams, now with Shearman & Sterling in Washington, characterized section 7525 as having more holes than Swiss cheese. And David W. Aughtry of Chamberlain, Hrdlicka, White, Williams & Martin in Atlanta said a recent statutory change has created the "hole that may consume the whole."

Auditor Tension

A controversy is brewing between the accounting and legal professions over the nature of documents and details that auditors should review to certify the financials of a company in the wake of the Sarbanes-Oxley legislation, according to Williams.

The Supreme Court has held that auditors are public watchdogs, which is a public declaration that any communications with them are not designed for confidentiality, Williams said. Even just showing the auditors a document, without giving it to them, amounts to waiver, he said.

The Supreme Court has held that auditors are public watchdogs, which is a public declaration that any communications with them are not designed for confidentiality, Williams said.

In the Tax Court, where the attorney-client privilege is a rule of evidence, Williams said, an inadvertent waiver could result in a subject matter waiver of all communications otherwise subject to the privilege.

While privilege waiver can have broad-reaching effects, depending on the circuit, Williams said, work product doctrine waiver is limited in scope. Courts protect against the broad-based application of waiver to work product, he said, adding that it usually applies only to particular documents on a narrow point.