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Investigation into the Marriage Penalty under the Alternative Minimum Tax

Michael S. Keane
San Diego State University
Email: mkeane@mail.sdsu.edu

Nathan Oestreich
San Diego State University
Email: drno@sdsu.edu

James E. Williamson
San Diego State University
Email: james.williamson@sdsu.edu

ABSTRACT

That there is marriage penalty in the federal income tax is well documented. There is also structural penalty in the alternative minimum tax [AMT]. This paper represents an initial investigation of the magnitude of the AMT marriage penalty and how various factors affect it. Calculations of the marriage penalty based on various assumed levels of deductions and AMT adjustments are developed. The AMT does not add significantly to, or reduce, the marriage penalty in the regular tax.

KEYWORDS: Marriage Penalty, Alternative Minimum Tax

INTRODUCTION

The fact that there is marriage penalty in the federal income tax is well documented. The structural penalty was partially removed in the Bush tax cuts and extended by the American Taxpayer Relief Act of 2012, but Congress only adjusted the standard deduction and the tax rate for lower-income taxpayers whose income did not exceed the 25 percent bracket (i.e., income in the 10 percent, 15 percent, and 25 percent brackets). Although the structural penalty has been removed for the vast majority of taxpayers, there are many provisions of the Internal Revenue Code [Code] that can result in a married couple paying more tax than they would as unmarrieds. These include the residence interest limits ($1 million limit for acquisition debt and $100,000 limit for home equity debt are the same for married couples and unmarrieds), actively managed rentals under the passive activity loss limits ($25,000 limit and phase-out beginning at $100,000 is the same for a married couple as it is for unmarrieds), limits and phase-outs for the earned income tax credit, and the $3,000 capital loss deduction limit.

There is structural penalty in the alternative minimum tax [AMT] as well. Structurally, three differences have been identified: (1) the AMT exemption (Revenue Procedure 2015-53, 2015), is $83,800 for a married couple and $53,900 for unmarrieds (two unmarrieds get $107,800, which is $24,000 more than a married couple), (2) the AMT exemption phase out begins at different levels and (3) for marrieds and unmarrieds the 28 percent bracket kicks in at alternative minimum tax base of $$186,300 (Code § 55 and Revenue Procedure 2015-53, 2015)). The AMT is 26% from AMT base of $0 to $$186,300, 28%, over $186,300.

This paper represents an initial investigation of the magnitude of the AMT marriage penalty and how various factors affect it. A spreadsheet has been developed to calculate the marriage penalty based on assumed levels of deductions and AMT adjustments.

OVERVIEW OF AMT, AMT ADJUSTMENTS, AND AMT PREFERENCES

The AMT is imposed in § 55 of the Code. A taxpayer pays the larger of the regular tax or the tentative AMT. The formula for determining the tentative AMT follows:

Regular income tax
Plus or minus AMT Adjustments
Plus AMT preferences
Equals: Alternative minimum taxable income
Minus the AMT exemption
Equals: AMT base
Times: AMT tax rate
Equals: Tentative AMT (net of specified credits)
Minus: Regular income tax
Equals AMT

Detailed descriptions are not provided here, but the following paragraphs include summaries of characteristics.

AMT Adjustments.

Adjustments can be positive or negative. For example, depreciation must be recalculated for AMT generally using slower methods. With respect to a particular asset, the adjustment may be positive in one year and negative in a later year after what is called the turn-around point is passed. For example, for 5-year property, double declining balance is used for regular tax and 150 percent declining balance is used for AMT. No adjustment is made for § 179 write-offs or for additional first-year depreciation (as a result, they are allowed for AMT purposes). Similar rules apply to mining exploration costs and long-term contracts. Similarly, a net operating loss deduction must be calculated using AMT concepts. (Code § 56).

For individual taxpayers, a number of deductions are disallowed or recalculated. One of the ones most significant for large families is that the personal and dependency exemptions are lost. Individuals also lose their deductions for state and local income taxes in total, and they may lose all or part of their deductions for medical expenses and interest.

Another adjustment that can have substantial, even crippling effects in extreme cases, is the adjustment for incentive stock options. There is a positive adjustment in the year of exercise equal to the bargain element (i.e., fair market value – option price). If the stock has appreciated significantly, this can create or increase the AMT in large ways. In the year of sale, the adjustment is reversed (i.e., a negative adjustment in the same amount), but there may not be enough income to absorb this adjustment so there may be no AMT that year.

AMT Preferences.

AMT preferences are always positive. They include the excess of percentage depletion allowed over the taxpayer's basis in the asset and excludable municipal bond interest on specified private development bonds (Code § 57).

AMT Exemptions.

The AMT exemption is a deduction allowed in calculating the AMT base (Code § 55(d)). For 2016, the exemption is $83,800 for married taxpayers and $53,900 for unmarried ones. These amounts are adjusted for inflation (Revenue Procedure 2015 – 53, 2015).

For higher income taxpayers, the exemption is phased out at a rate of 25 percent of AMTI in excess of specified thresholds. For married taxpayers the 2016 threshold is $159,700; for unmarried taxpayers, $119,700 (Revenue Procedure 2015 – 53, 2015).

Since the exemption is phased-out as income increases, the effective rate in the 26 percent bracket is 32.5 percent (26 percent x 1.25); in the 28 percent bracket, 35 percent (28 percent x 1.25).

AMT Tax Rate.

As previously mentioned, the tax rate is 26 percent from AMT base of $0 to $186,300, and 28 percent for base in excess of $186,300. The $186,300 amount is adjusted annually for inflation (Revenue Procedure 2015 – 53, 2015).

EXAMPLES

The first step in an analysis of this nature is to develop scenarios to observe the nature of relationships between the relevant variables. Then further analysis can be undertaken to quantify the relationships and reach conclusions.

Zero Taxable Income

In this scenario, adjusted gross income is set at exactly the sum of the standard deduction and the personal and dependency exemptions. The regular tax is therefore zero. The adjustments necessary for singles to create an AMT equals the exemption amount of $53,600 (2015 amount).

Exemption	$83,400	$53,600	$53,600
AGI	$20,600	$10,300	$10,300
Exemptions	$8,000	$4,000	$4,000
Standard deduction	$12,600	$6,300	$6,300
TI	$0	$0	$0
Adjustments	$107,200	$53,600	$53,600
AMT base	$23,800	$0	$0
Tent. AMT	$6,188		
Marriage penalty	$6,188		

A married couple with exactly the same amount of adjustments will pay AMT of $6,188. This is the marriage penalty, which is caused solely by the difference in AMT exemption amounts.

It is significant that the amount of adjustments to hit AMT is $53,600, and unlikely, but not an impossible amount. If the taxpayer had a business with large deductions and adjustments, she could get there. Another way, that will be developed later, would be to have more dependency exemptions and large itemized deductions for state and local taxes and miscellaneous itemized deductions.

Income of $100,000

This example verifies that the penalty does not change for a couple earning $50,000 each when they still claim personal and dependency exemptions and the standard deduction.

AGI	$100,000	$50,000	$50,000
Exemptions	$8,000	$4,000	$4,000
Standard deduction	$12,600	$6,300	$6,300
TI	$79,400	$39,700	$39,700
Income tax	$11,438	$5,719	$5,719
Adjustments	$71,790	$35,895	$35,895
AMT base	$67,790	$21,995	$21,995
Tent. AMT	$6,188	$0	$0
Marriage penalty	$6,188		

The marriage penalty is still $6,188. Here, however, the adjustments necessary to encounter AMT is only $35,895 each.

Income of $100,000 with Head of Household

A head of household is entitled to a larger standard deduction than other singles ($9,250 versus $6,300). This example, which also increases the exemptions from two to four, investigates whether head of household status has any effect.

AGI	$100,000	$50,000	$50,000
Exemptions	$16,000	$8,000	$8,000
Standard deduction	$12,600	$9,250	$9,250
TI	$71,400	$39,700	$39,700
Income tax	$12,173	$5,719	$5,719
Adjustments	$71,790	$23,000	$35,895
AMT base	$67,790	$9,100	$21,995
Tent. AMT	$6,188	$0	$0
Marriage penalty	$6,188		

The marriage penalty is still $6,188. It is true that the standard deductions will be included in the adjustments, which in this case need to be $23,000 for one and $35,895 for the two individuals, one of whom claims one exemption; the other, three.

Income of $100,000 with Itemized Deductions

This situation adds the complexity when one person claims itemized deductions and the other the standard deduction. If they marry and file jointly, the couple must either itemize or claim the standard deduction. In this case, the couple itemizes on their joint return, and they lose the one standard deduction.

AGI	$100,000	$50,000	$50,000
Exemptions	$16,000	$4,000	$12,000
Itemized/standard			

deduction	$30,000	$28,000	$6,300
TI $54,000 $18,000 $31,700			
Income tax	$7,118	$2,239	$4,294
Adjustments	$82,626	$44,212	$38,414
AMT base	$53,226	$8,612	$16,514
Tent. AMT	$6,721	$0	$0
Marriage penalty	$6,721		

In this particular case, there is a regular tax penalty of $586 ($7,118 - $2,238 - $4,294), and an AMT marriage penalty $6,721. Notice that the joint itemized deductions were only $2,000 more than the one person's itemized deductions. This assumes that the person's itemized deductions were $2,000, and elected to claim the larger standard deduction as an unmarried taxpayer.

Income of $400,000 with Itemized Deductions

Now, we expand the analysis to the point where the 28% AMT tax rate plays a role (i.e., when AMTI exceeds $$186,300). When single, one taxpayer itemizes and files as single; the other, the standard deduction and head of household.

AGI	$400,000	$250,000	$150,000
Exemptions	$0	$8,000	$8,000
Standard/Itemized	$92,331	$92,000	$9,250
TI	$307,669	$150,000	$132,750
Income tax	$76,944	$35,127	$27,563
Adjustments	$43,784	$24,904	$18,880
AMT base	$321,437	$135,105	$106,013
Tent. AMT	$86,276	$35,127	$27,563
Marriage penalty	$23,586		

Here, the marriage penalty rises due to a combination of multiple factors. There is a $16,046 regular tax penalty primarily because of the different tax brackets and the $400,000 AGI results in loss of the exemption deduction and a cut-back of itemized deduction.

Since the AMT is the tentative AMT minus the regular tax, the amount of adjustments for the unmarried to make the tentative AMT and the regular tax equal is determined. If the married couple had exactly that amount of adjustments, the AMT marriage penalty is $25,106, that when added to the regular tax penalty totals $41,152. Some of the factors contributing to this higher penalty are the 28 percent AMT tax bracket on AMT base over $186,300, the difference in AMT exemptions (that now straddles the 28 percent and 26 percent AMT tax brackets), and the phase-out of the AMT exemption. Nearly the entire exemption for married is phased out, while smaller amounts are phased out for unmarrieds.

CONCLUSIONS AND PLANNED FUTURE ANALYSIS

The examples here are the first steps to analyze the marriage penalty in the AMT. The basic penalty caused solely by the differences in AMT exemptions was found to be $6,188. As higher income and different mixes of deductions are introduced, the penalty may increase (and possibly decrease).

Since Congress increased the AMT exemptions and indexed them for inflation, the amount of adjustments and preferences needed for middle-income taxpayers to incur AMT has generally increased. Accordingly, the probability of having to pay the tax has decreased. The possibility is real for some, which increases the complexity of their tax compliance and planning. Policy makers and taxpayers, alike, should be aware of these factors.

In orders of magnitude, the marriage penalty appears to be much less of an issue for the AMT, as compared to the regular tax. Further study will investigate this and other issues for married taxpayers.

For subsequent analysis the calculations will be verified. By the nature of the assumptions that are made, they are essentially close estimates at this point in the analysis.

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Internal Revenue Code § 55

Internal Revenue Code § 56

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