

August 2000**ALTERNATIVE
MINIMUM TAX****An Overview of Its
Rationale and Impact
on Individual
Taxpayers****G A O****Accountability * Integrity * Reliability**



G A O

Accountability * Integrity * Reliability

United States General Accounting Office
Washington, D.C. 20548

General Government Division

B-285738

August 15, 2000

The Honorable William V. Roth, Jr.
Chairman, Committee on Finance
United States Senate

Dear Mr. Chairman:

This report responds to your request for a nontechnical primer on the alternative minimum tax (AMT) for individuals, which is intended to help ensure that high-income individuals do not avoid significant tax liability. In general, AMT is a separate tax system that parallels the regular individual income tax system. Under this dual system of taxation, taxpayers are required to first compute their tax liability under regular income tax rules and then, if their income or tax payments do not meet certain tests, they are required to recompute their tax liability using the AMT rules. Taxpayers are then obligated to pay the greater of the two.

Although relatively few taxpayers have been affected financially by AMT in the past, recent research at the Department of the Treasury estimated that about 17 million taxpayers would pay additional taxes under AMT by 2010. Given your concerns about the complexity of the AMT rules and the fact that many more taxpayers would be affected, you asked us to provide a report summarizing

- the rationale for establishing AMT,
- how AMT affects taxpayers' tax liability,
- the expected increase in AMT coverage and additional tax liability and the major reasons for the increase, and
- the impact of the projected increase in AMT coverage on taxpayers' compliance burden and economic incentives and on the distribution of the tax burden.

As agreed with your office, this report is based on our review of the AMT tax law provisions, legislative history, and materials published by tax law experts in both the private sector and federal government. We did our work in Washington, D.C., during June and July 2000 in accordance with generally accepted government auditing standards.

Results in Brief

AMT was created to reduce the ability of individuals to escape payment of tax on income by using tax preferences (e.g., items excluded from income subject to tax) available under the regular tax system. A type of minimum tax was first enacted in 1969, following congressional testimony by the Secretary of the Treasury reporting that 155 high-income individuals paid no federal income tax in 1966. Over the intervening years, the minimum tax has been amended a number of times, producing today's AMT. The legislative history for AMT indicates that as Congress amended the law, the overriding objective remained constant.

AMT can affect taxpayers' tax liability in two ways: (1) directly, by imposing an AMT liability that exceeds their regular tax liability, or (2) indirectly, by reducing the amount of certain tax credits allowable under the regular income tax. After calculating their taxes under the regular income tax, many taxpayers must complete a series of forms and calculations to determine if they are affected by AMT. If this exercise shows that they may be affected by AMT, taxpayers must recalculate their taxable income and tax liability using rules that differ from the regular income tax. To date, recent research at the Joint Committee on Taxation (JCT) and Treasury has indicated that AMT has affected relatively few, mostly higher-income, taxpayers and has generated a relatively small amount of tax liability in addition to the regular income tax. According to the research at Treasury, for example, AMT is expected to affect about 1.3 million taxpayers—about 1.3 percent of all taxable returns—and generate a projected \$5.8 billion in additional tax liability in 2000.

According to the research at JCT and Treasury, however, the number of taxpayers affected by AMT and the corresponding tax liability generated are expected to increase substantially over the next 10 years. For example, according to the research at Treasury, the number of taxpayers affected financially by AMT is expected to increase from about 1.3 million in 2000 to 17 million in 2010—almost 16 percent of all taxable returns—and the additional tax liability generated by AMT is projected to grow from \$5.8 billion to \$38.2 billion during the same period. Of the projected 17 million taxpayers affected by AMT in 2010, about 4.5 million are expected to have reduced tax credits due to AMT, even though they are not projected to have a direct AMT liability.

The projected increases in AMT coverage and additional tax liability are primarily attributable to the following: (1) unlike the regular tax system, the AMT system is not indexed to account for inflation and (2) the legislation that excludes personal tax credits from AMT rules will expire in 2001. According to research at Treasury, the annual effects of these two

AMT features are expected to have increasing budgetary significance in future years. In 2010, AMT's lack of inflation adjustments and limitation of personal credits (beginning in 2002) are estimated to account for about \$24 billion and about \$7 billion in additional tax revenues, respectively.

The projected increase in AMT coverage and the complexity of the system would significantly add to the overall compliance burden on taxpayers and the administrative burden on the Internal Revenue Service (IRS). AMT's projected increase would also affect the distribution of taxes among individuals. On the one hand, AMT generates taxes from some higher-income individuals who would otherwise have paid no taxes. On the other hand, it is projected to shift from affecting mostly higher-income individuals to more middle-income taxpayers between 2000 and 2010 and may also affect certain economic incentives created by the regular tax system. Additionally, changes that reduce taxes under the regular tax system, absent corresponding changes to AMT, may result in an increase in the number of individuals covered by AMT and thus partially neutralize the benefits of the tax changes.

We provided copies of a draft of this report to the Secretary of the Treasury and Commissioner of Internal Revenue for comment. Those comments are discussed at the end of this letter and mostly involve technical clarifications. Additionally, Treasury officials suggested that our report be refocused to emphasize "design" or "structural flaws" of AMT features and to analyze the extent to which the features fulfill AMT's purpose. Developing data sufficient to make judgments such as these was outside the scope of our review, which was to provide a primer (i.e., a brief introduction) on AMT, including a summary of its rationale and impact on taxpayers.

AMT Was Designed to Increase the Likelihood That Higher Income Taxpayers Have Some Tax Liability

In 1969, Congress enacted an add-on minimum tax that served as the predecessor to the current AMT. It was designed to reduce the ability of higher income individuals to escape payment of tax on income. Its enactment followed congressional testimony by the Secretary of the Treasury reporting that 155 individuals, each with adjusted gross incomes (AGI) above \$200,000 (about \$1.1 million in fiscal year 2000 dollars) as defined under the regular tax system, paid no federal income tax in 1966.

Since 1969, the minimum tax has been amended a number of times, most notably in 1976, 1978, 1982, 1986, 1990, and 1993. Through these amendments, the minimum tax was changed from essentially a surcharge on certain tax preference items (i.e., items excluded from taxable income under the regular tax but taxable under the minimum tax) to a separate tax

system, paralleling the regular income tax, with its own definition of income subject to tax and its own tax rates.

In general, the changes were enacted to help ensure that all taxpayers with significant amounts of income pay at least a minimum amount of tax. For example, the Senate report for the Tax Reform Act of 1986 emphasized that the overriding objective of the change was to ensure that no taxpayer with substantial income should be able to avoid significant tax liability by using tax preferences available under the regular tax system.¹

AMT Affects Taxpayers' Tax Liability in Two Ways

AMT may affect taxpayers' tax liability in two ways: (1) directly, by imposing an AMT liability that exceeds their regular tax liability, or (2) indirectly, by reducing the amount of tax credits allowable under the regular income tax. To date, AMT has affected relatively few, principally higher income, individuals and has generated a small percentage of tax liability in addition to the regular income tax.

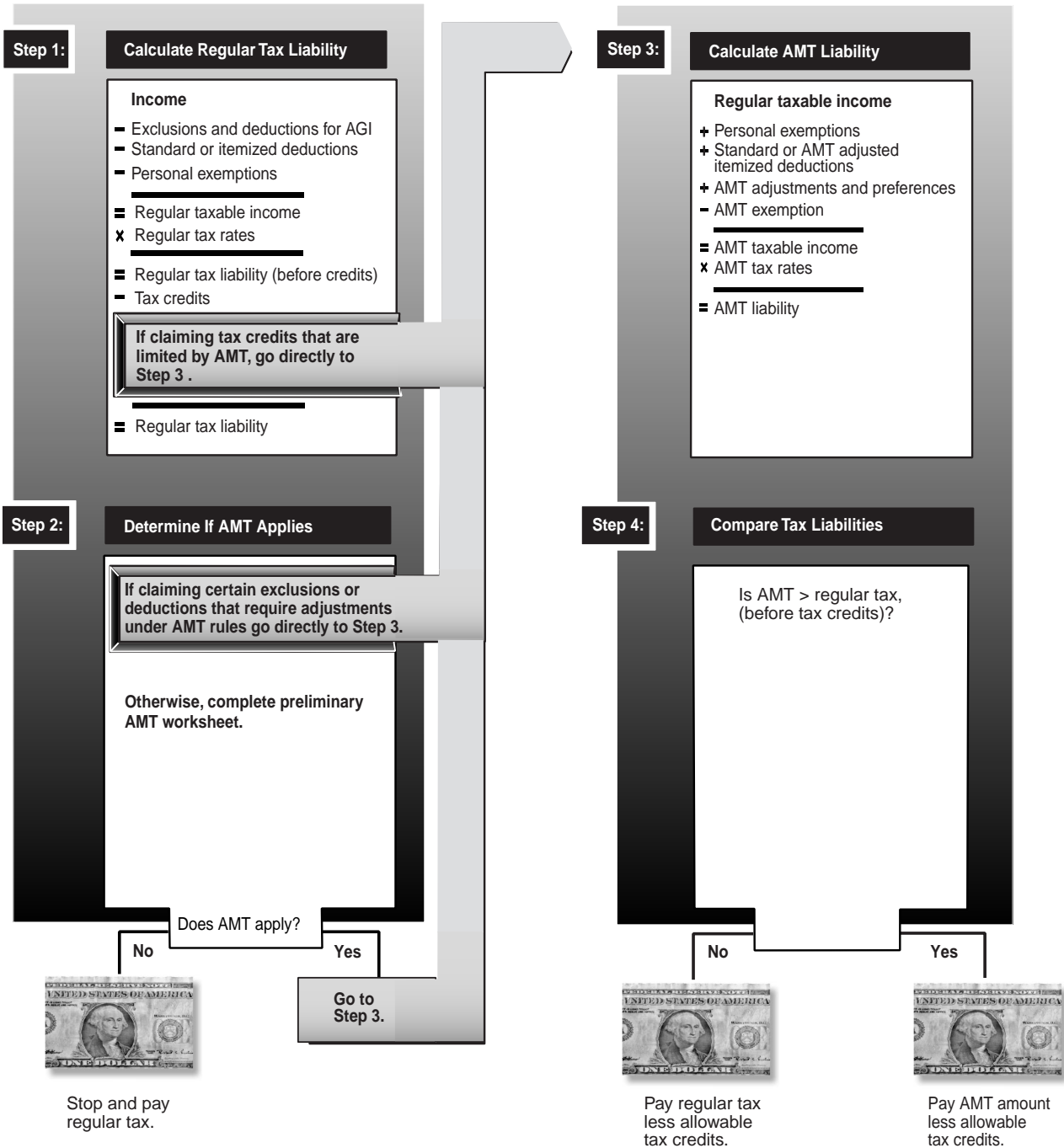
AMT Structure and Rules Differ From the Regular Income Tax

In general, AMT is a separate tax system that parallels the regular individual income tax system. It generates an alternative tax liability by applying different tax rates to a broader base of income than under the regular individual income tax system and limits the use of certain tax credits available under the regular income tax. As illustrated in figure 1, taxpayers complete a series of steps to determine if they are affected by AMT.² In general, they calculate their regular tax liability and complete a preliminary AMT worksheet. Then if so indicated by that worksheet, they calculate their AMT liability, compare the two tax liabilities, and pay the greater of the two.

¹See S. Rept. No. 313, 99th Cong., 2d sess., p. 520.

²This illustration generally applies to individual taxpayers required to file IRS Form 1040, U.S. Individual Income Tax Return.

Figure 1: Simplified Illustration of Regular Income Tax and AMT



Source: GAO analysis.

First, Taxpayers Calculate Their Regular Tax Liability

As the first step in the process, taxpayers calculate their tax liability based on their taxable income under the regular income tax. To determine taxable income, taxpayers report various items of income³ and then

- subtract items for determining AGI,⁴
- subtract the standard or itemized deductions,⁵ and
- subtract personal exemptions.⁶

Next, taxpayers determine their regular tax liability by applying the appropriate tax rate to this taxable income amount. The regular individual income tax has five marginal tax rates: 15 percent, 28 percent, 31 percent, 36 percent, and 39.6 percent for tax year 1999.⁷ The regular income tax also provides special tax rates for long-term capital gains.

Finally, taxpayers may reduce their regular tax liability with certain tax credits. The AMT rules, however, may limit the use of some credits. Under current law, taxpayers generally may not use certain tax credits, most notably the general business credit, to reduce their regular tax liability to an amount less than their AMT. For such taxpayers, AMT serves as a floor for the regular income tax below which allowable credits are disallowed but may be carried over to another tax year. Taxpayers with credits limited by AMT are required to go to step 3 in figure 1, bypassing step 2, in order to determine the extent to which AMT limits apply.

Under current law, personal tax credits, such as the child and education credits, are temporarily excluded from the AMT rules through 2001.⁸

³While generally all income is subject to tax, some types of income are excluded, such as interest on tax-exempt bonds.

⁴Deductions for determining AGI are certain items that are specifically exempt or excluded from gross income by statute, such as the deduction for IRA contributions, moving expenses, and alimony.

⁵In 1999, the standard deduction was \$4,300 for single filers; \$6,350 for heads of household; \$7,200 for married, filing jointly; \$3,600 for married, filing separately.

⁶Personal exemptions are based on the number of dependents claimed by a taxpayer. In 1999, personal exemptions were \$2,750 for each qualifying exemption, subject to phase-outs based on taxpayer income.

⁷The marginal tax rates under the regular income tax are applied to amounts of taxable income that depend on filing status. E.g., the tax for married taxpayers filing jointly is 15 percent of the first \$43,050 in taxable income; \$6,458 plus 28 percent of taxable income between \$43,050 and \$104,050; \$23,358 plus 31 percent of taxable income between \$104,050 and \$158,550; \$40,433 plus 36 percent of taxable income between \$158,550 and \$283,150; and \$85,289 plus 39.6 percent of taxable income over \$283,150.

⁸The Omnibus Consolidated and Emergency Supplemental Appropriations Act of 1998 allowed taxpayers to claim their personal credits—including the child and education credits—in full against

Beginning in 2002, though, these personal credits would be limited by AMT.

Second, Taxpayers Determine Whether AMT Applies

As the second step, taxpayers determine whether they may be subject to AMT as follows.

- Taxpayers that claim certain AMT preference items under the regular income tax that are considered AMT adjustments or preferences are automatically subject to the AMT rules and are to proceed directly to step 3—calculate AMT liability.⁹
- Other taxpayers are to complete a worksheet that contains a series of income tests designed to determine whether a taxpayer's income exceeds a preliminary threshold according to the basic AMT rules.¹⁰ If the worksheet shows that their income exceeds the threshold, taxpayers must continue to step 3—calculate AMT liability. If the worksheet shows that their income does not exceed the threshold, taxpayers pay their regular tax liability without having to complete steps 3 and 4 in figure 1.

Third, Some Taxpayers Calculate AMT Liability

As the third step, taxpayers subject to AMT compute their AMT liability using the AMT form,¹¹ which requires them to recalculate their taxable income and tax liability using rules that differ from the regular income tax. To calculate taxable income under AMT, taxpayers essentially start with the taxable income amount reported under the regular system and then do the following.

- **Add back their personal exemptions that were allowed under the regular income tax.**
- **Add back the standard or certain AMT-adjusted itemized deductions that were allowed under the regular income tax.** AMT requires taxpayers to adjust certain itemized deductions taken under the regular income tax. For example, AMT disallows the deduction for state and local taxes and only allows for the deduction of medical expenses

their AMT liability for the single tax year beginning after December 31, 1997. The Ticket to Work and Work Incentives Improvement Act of 1999 extended that provision through 2001.

⁹Appendix I identifies the items that automatically subject taxpayers to the AMT rules in step 2 of figure 1.

¹⁰The worksheet is provided in the instructions to IRS forms 1040 and 1040A.

¹¹The AMT form is IRS Form 6251, the Alternative Minimum Tax-Individuals. This form, when necessary, is to be attached to IRS Form 1040, U.S. Individual Income Tax Return.

above 10 percent of AGI.¹² However, AMT does not disallow or adjust all itemized deductions. For example, AMT does not require taxpayers to add back certain mortgage interest or charitable contribution deductions to their taxable income. (See app. I for more details.)

- **Add other AMT adjustments and preference items taken under the regular income tax.** AMT disallows certain preference items and requires adjustments to other deductions available under the regular income tax, including some income excluded from the regular income tax. Many of these items are related to timing of deductions allowed for certain types of business investments. In effect, the elimination or adjustment of certain preference items expands the base of taxable income under AMT. (For a summary of AMT preference items and adjustments, see app. I.)
- **Subtract the AMT exemption amount based on filing status.** The AMT exemption amount, which is subject to phase-out depending on taxpayer income computed under AMT rules, is generally intended to replace the personal exemptions and the standard deduction allowed under the regular income tax. However, the AMT exemption amount is not adjusted to account for family size. For example, married taxpayers filing jointly may reduce the AMT taxable income by \$45,000. The \$45,000 exemption amount is subject to a phase-out of 25 percent of AMT taxable income in excess of \$150,000.¹³
- **Taxpayers then calculate their AMT liability by applying the AMT tax rates to their AMT taxable income.** The AMT applies a 26-percent tax rate on the first \$175,000 of AMT taxable income and 28 percent of such income in excess of \$175,000.¹⁴

Fourth, Taxpayers Compare Tax Liabilities and Check the Use of Certain Tax Credits

As the fourth step, taxpayers essentially compare their regular tax liability (before credits) with their AMT liability, as shown in step 4 of figure 1. In general, if their AMT liability is greater than their regular tax liability (before credits), they must pay their AMT liability less any allowable credits. If their AMT liability is less than their regular tax liability (before

¹²Under the regular income tax, deductions are allowed for medical expenses in excess of 7.5 percent of AGI.

¹³The AMT exemption for single and head of household filers is \$33,750, subject to a phase-out of 25 percent for taxable income in excess of \$112,500. The AMT exemption amount for married individuals filing separately is \$22,500, subject to a phase-out of 25 percent of taxable income in excess of \$75,000.

¹⁴For married taxpayers filing separately, AMT applies the 26-percent tax rate to the first \$87,500 of AMT taxable income and the 28-percent rate on the excess. AMT also has special rules for taxing capital gains income, which generally preserves the lower capital gains tax rates of the regular tax system (e.g., 20-percent tax rate).

credits), they pay their regular tax liability less any allowable credits.¹⁵ As we described earlier, the AMT rules temporarily allow taxpayers to use personal credits without limitation. However, taxpayers generally may not use general business credits to reduce their regular tax liability to an amount less than their tax liability computed under the AMT rules. Also, taxpayers whose AMT liability exceeds their regular tax liability may not use certain refundable tax credits (e.g., the earned income tax credit) to reduce their AMT liability to an amount less than their tax liability computed under the regular tax.

The following example depicts how AMT limits general business credits. A taxpayer has a regular tax liability (before credits) of \$5,000, qualifies for \$1,500 in general business credits, and has an AMT liability of \$4,000. The taxpayer does not have a direct AMT liability, but can only take \$1,000 in general business credits and not the other \$500 because the taxpayer cannot use credits to reduce the regular tax liability below the AMT tax liability. As a result, the taxpayer's effective tax liability of \$4,000 is \$500 greater than it would have been absent AMT.

AMT Currently Affects Relatively Few Taxpayers

According to recent research at JCT and Treasury, AMT currently affects relatively few taxpayers and generates a relatively small portion of additional tax liability.¹⁶ However, it does require some taxpayers with income to remit more in tax than they would otherwise under the regular tax. For example, recent research at Treasury estimated that AMT would affect about 1.3 million taxpayers—about 1.3 percent of all taxable returns—and would generate about \$5.8 billion in additional tax liability in 2000. As shown in table 1, most of the affected taxpayers, both in terms of the number affected and percentage of AMT taxes paid, have been higher income individuals, as measured under the regular tax system. Additionally, according to recent IRS calculations, about 14,000 taxpayers

¹⁵The foreign tax credit can also be deducted from AMT. But it may not reduce AMT by more than 90 percent. Additionally, taxpayers may be able to use part of their AMT liability, if applicable, to offset their regular tax liability in the following year. Commonly referred to as the "AMT credit," this credit is subject to restrictive conditions, and few taxpayers are eligible for it.

¹⁶For reporting purposes, we used data estimates from recent research conducted at the Department of the Treasury's Office of Tax Analysis. See Robert Rebelein and Jerry Tempalski, Who Pays the Individual AMT?, Office of Tax Analysis Working Paper 87 (June 2000). All estimates in this paper were made using the Treasury Department's Individual Tax Model in combination with the administration's economic forecast from the FY 2001 Budget. This working paper notes that the views expressed in the paper do not necessarily represent official Treasury positions. Accordingly, we limited our use of the paper to the data produced by the Treasury models and refer to the working paper as recent research at Treasury. Also, JCT provided us with updated tables from its report, Present Law and Background Relating to the Marriage Tax Penalty, Education Tax Incentives, the Alternative Minimum Tax, and Expiring Tax Provisions (JCX-39-99).

would not have had any individual income tax liability absent AMT in tax year 1997.

Table 1: Projected AMT Taxpayers and Tax Liability in 2000

Adjusted gross income	Number of AMT taxpayers^a	Percentage of AMT tax liability
Less than \$0 ^b	^c	0.8
\$0-\$14,999	^c	0.1
\$15,000-\$29,999	^c	0.2
\$30,000-\$49,999	^c	0.4
\$50,000-\$74,999	0.1	2.2
\$75,000-\$99,999	0.2	6.5
\$100,000-\$199,999	0.5	22.5
\$200,000 or more	0.5	67.4
Total	1.3	100.0

Note: Totals may not sum because of rounding.

^aIn millions.

^bAn AGI less than 0 can occur due to a loss of some kind, such as a business loss.

^cLess than 50,000.

Source: Department of the Treasury, Office of Tax Analysis Working Paper 87 (June 2000).

AMT Coverage and Tax Liability Are Projected to Increase

According to recent research at JCT and Treasury, AMT coverage and tax liability are projected to increase dramatically between 2000 and 2010. For example, recent research at Treasury estimated that the number of taxpayers affected financially by AMT is projected to grow at an average rate of 31 percent per year after 2000, and by 2010, AMT is expected to affect almost 16 percent of all taxable returns and generate about \$38 billion in additional tax liability. The expected increases are primarily attributable to the fact that, unlike the regular income tax, AMT is not indexed to account for inflation and that the legislation that excludes personal tax credits from the AMT rules is set to expire in 2001.

Extent of AMT Coverage and Tax Liability Increases

Recent research at Treasury indicated that the number of taxpayers affected by AMT under current law is projected to expand from about 1.3 million in 2000 to about 17 million in 2010—a 31-percent average increase per year. The corresponding additional AMT liability is projected to increase from about \$5.8 billion to about \$38.2 billion from 2000 to 2010—a 21-percent average increase per year.

The projected increase in the number of taxpayers affected financially by AMT under current law include both those with direct AMT liabilities and those with reduced tax credits due to AMT. The number of individuals with a direct AMT liability is projected to increase from 1.2 million in 2000 to

12.5 million in 2010.¹⁷ In addition, the number of individuals with reduced tax credits due to AMT is projected to increase from 100,000 in 2000 to 4.5 million in 2010, even though they are not projected to have a direct AMT liability.

The additional tax liability generated by AMT is projected to increase rapidly from both taxpayers with a direct AMT liability and those with reduced credits due to AMT. The additional tax liability generated from individuals with direct AMT liabilities is projected to increase from \$3.4 billion in 2000 to \$26.4 billion in 2010. The additional tax liability generated from individuals with credits lost due to AMT is projected to increase from \$2.4 billion in 2000 to \$11.8 billion in 2010.

Increased AMT Coverage Primarily Attributable to the Absence of Inflation Adjustments and Expiration of Personal Tax Credit Exclusion

The projected increases for the individual AMT are attributable to the fact that, unlike the regular income tax, the AMT parameters are not indexed to account for inflation. Additionally, the expiration of legislation that excludes personal credits from the AMT rules contributes to the projected increase in AMT coverage and additional tax liability.

In the regular income tax system, the personal exemptions, standard deduction, and tax rate brackets are indexed for inflation. Under AMT, however, the exemption amounts, the threshold phase-out amounts for these exemption amounts, and the AMT rate brackets are not indexed for inflation.

The lack of inflation indexing in AMT causes taxpayers' AMT liabilities to increase faster than their regular tax liabilities. Real income growth—growth above inflation—will increase both regular tax and AMT liabilities. However, income growth due to inflation will generally not increase regular tax liabilities because of inflation indexing, but it will increase AMT liabilities. The result is that, over time, more taxpayers will have an AMT liability that exceeds their regular tax liability, even if inflation continues to remain relatively low, as it has over the past few years.

Another contributing factor to the projected increases in AMT is the expiration in 2001 of the legislation that Congress enacted to temporarily exclude personal credits from limitation under the AMT rules. As we described earlier, personal tax credits are to be subject to limitation under the AMT rules beginning in 2002. Recent research at Treasury estimated that the number of taxpayers with reduced credits would increase from

¹⁷Of the estimated 12.5 million taxpayers with a direct AMT liability in 2010, 4.9 million are also projected to have reduced tax credits.

200,000 in 2001 (the last year of the personal credits exclusion) to 2 million in 2002 and would rise to 9.4 million in 2010. According to JCT, the recently enacted child and education credits are expected to be affected the most.¹⁸

Slower Growth Projected Under an AMT That Is Adjusted for Inflation and That Does Not Limit Tax Credits

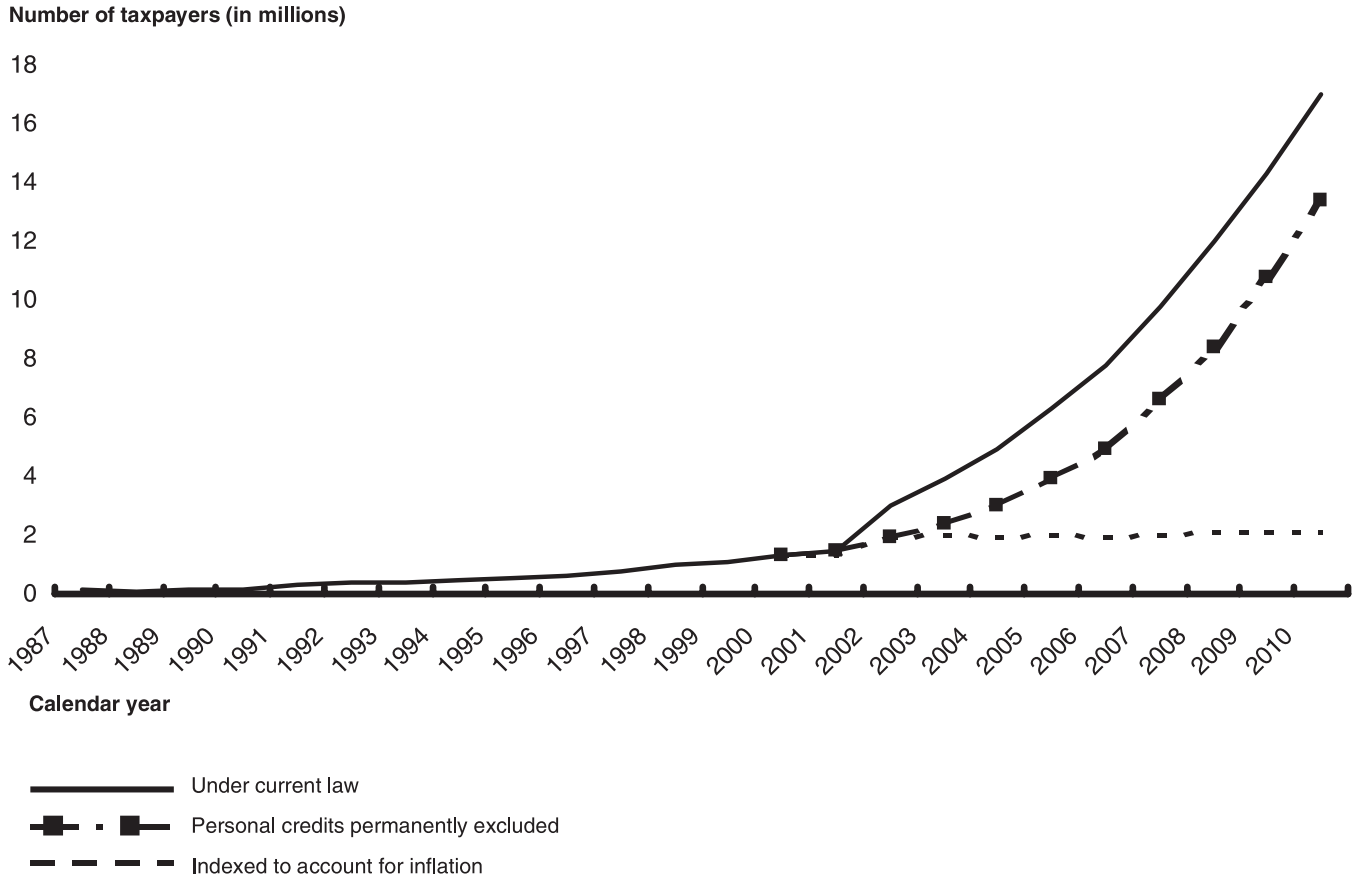
If the AMT parameters were indexed to account for inflation starting in 2000, according to recent research at Treasury (illustrated in fig. 2), the projected number of taxpayers affected financially by AMT over time would be relatively constant and significantly less than under current law.¹⁹ The number of individuals affected by an inflation-adjusted AMT is estimated at 2.1 million in 2010 compared to 17 million under current law. This projected reduction is expected to occur for both taxpayers with a direct AMT liability and those with reduced credits. Also, if Congress permanently extended the legislation excluding personal tax credits from the AMT rules, the projected number of taxpayers affected financially by AMT and the corresponding revenue generated would also be lower than under current law.²⁰ As figure 2 shows, recent research at Treasury estimated that under this scenario, about 13.4 million taxpayers would be affected by AMT in 2010 compared to 17 million under current law.

¹⁸The Child Credit, the HOPE education credit, and the Lifetime Learning Credit are provisions of the regular income tax that were enacted in the Taxpayer Relief Act of 1997.

¹⁹Under this scenario, personal tax credits would be limited by the AMT rules beginning in 2002.

²⁰This scenario does not include inflation adjustments for the AMT parameters.

Figure 2: Actual and Projected Number of Taxpayers Affected Financially by AMT

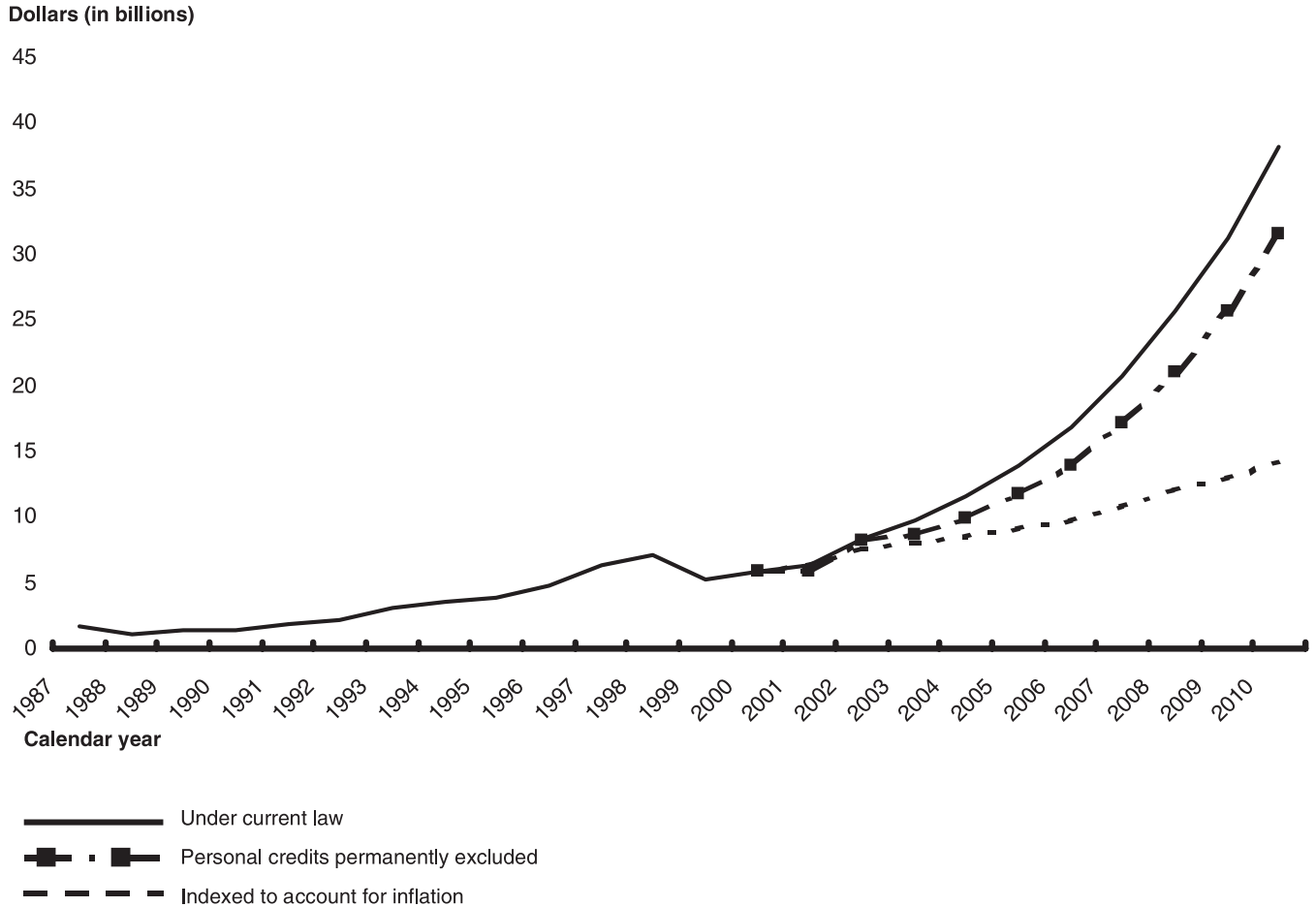


Note: This figure contains a combination of actual and projected data. Pre-1998 data on the number of taxpayers are actual values, the 1998 data have both actual and projected components, and the 1999-2010 data are all projections.

Source: Department of the Treasury, Office of Tax Analysis Working Paper 87 (June 2000).

As figure 3 shows, the recent research at Treasury also indicated that indexing AMT to account for inflation and permanently excluding personal credits from limitation under the AMT rules would have a significant budgetary impact over time. The projected additional revenues for an inflation-adjusted AMT (both direct payments and reduced credits) are expected to grow at a slower rate and account for an amount significantly less than projected under current law—about \$24 billion less in 2010. The projected additional revenue generated by AMT with personal credits permanently excluded would be \$6.7 billion less than the \$38.2 billion projected under current law in 2010.

Figure 3: Actual and Projected Additional Tax Liability From AMT



Note: This figure contains a combination of actual and projected data. Pre-1998 tax liabilities are actual values, the 1998 tax liability has both actual and projected component, and the 1999-2010 tax liabilities are all projections.

Source: Department of the Treasury, Office of Tax Analysis Working Paper 87 (June 2000).

Increased AMT Coverage Would Have a Number of Impacts

The projected increase in AMT coverage, coupled with the system's complexity, would add significantly to the overall compliance burden on taxpayers and the administrative burden on IRS. The projected increases would also affect the distribution of the tax burden among taxpayers and may change the economic incentives created by the tax system. Additionally, under current law, AMT could neutralize future changes to the regular tax system.

Increased AMT Coverage Would Affect Taxpayers' Compliance Burden

As the projected number of individuals affected by the complex AMT rules increases over time, the overall compliance burden of the tax system on taxpayers will increase. While it is difficult to concretely measure compliance burden, there is common agreement that AMT can significantly complicate the filing situation for taxpayers. The National Taxpayer Advocate ranks AMT as one of the most burdensome areas of tax law.²¹ Additionally, in a recently released report on tax law complexity,²² IRS states that the complex calculations and extensive linkages between forms and worksheets (as illustrated in fig. 1) associated with AMT impose a substantial burden on taxpayers. Taxpayers often bear this burden only to determine that they do not have an AMT liability. According to IRS, of the 4.4 million taxpayers that filed the AMT form, only 20 percent of them were affected financially by AMT in tax year 1997. Another indicator of AMT complexity is that 93 percent of the 4.4 million AMT filers used paid preparers in 1997 compared to about 52 percent of all individuals.²³

A significant portion of AMT compliance burden is attributable to the complexity of the AMT rules. As we described earlier, AMT is a parallel tax to the regular income tax. As such, AMT requires taxpayers to compute their regular tax liability and then recompute their AMT liability using a different base of income, different exemptions, and different tax rates. AMT applies different treatments to certain income deductions, exclusions, and credits that may be used by taxpayers under the regular income tax. As a result, affected taxpayers are required to apply two methods of accounting to some of these items—one for the regular tax and one for AMT. The complexity of the system can lead to uncertainty for taxpayers. For example, the withholding system on wages—the principal system used by individual taxpayers to deposit funds with IRS to cover their tax bill—is based on income and exemptions as defined by the regular tax system, not AMT.

IRS has identified a number of AMT provisions that add to complexity. These provisions include

- special rules for allowing portions of prior-year AMT tax payments to offset future-year regular tax liability under certain conditions,

²¹FY 1999 National Taxpayer Advocate's Annual Report to Congress, IRS Publication 2104 (Rev.12-99).

²²Annual Report from the Commissioner of the Internal Revenue Service on Tax Law Complexity (June 2000), pp. 19-29.

²³According to IRS, it is not clear whether the AMT filers used paid preparers specifically because of AMT.

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- recalculations of depreciation expenses under AMT rules that differ from the regular tax, and
 - additional calculations for married taxpayers who consider filing separately in order to determine the appropriate amount of tax liability.

According to IRS and Treasury officials, the complexity of calculating AMT liability can be most problematic for married taxpayers who consider filing separately. AMT, like the regular tax, establishes procedures that are intended to minimize or eliminate that ability of some taxpayers to allocate income arbitrarily between spouses to reduce their tax liability. If married taxpayers were to follow all recommended procedures, they would have to compute their taxes four different ways. First, they would need to compute their regular tax as if they were filing jointly and then again as if filing separately. Then they would need to determine their AMT tax as if filing jointly and then again as if they were filing separately. From these computations, the taxpayers could then determine which filing method is most appropriate for them.

Increased AMT Coverage Would Affect IRS Administration

The complexity of AMT and increases in the number of taxpayers affected also would complicate IRS' efforts to administer the federal tax system. Despite the frequent involvement of paid preparers in filing AMT returns, administering AMT does not just involve annually processing over 4 million AMT returns and crediting taxpayer accounts with the payments. According to IRS, it responded to about 6,400 calls from taxpayers about AMT issues in 1999 and dealt with errors on about 10 percent of taxpayer returns with a direct AMT liability.

Moreover, according to IRS, AMT is not an add-on to the existing tax system that involves just computer-checking calculations on a return. Some aspects can only be verified through office or field audit. According to IRS, the frontline employees who do such verification work consistently rank AMT as one of the most complex provisions with which they deal.

Increased AMT Coverage Would Affect Distribution of Tax Burden

The increase in AMT coverage would affect how the tax burden is distributed among taxpayers. On the one hand, AMT requires some taxpayers with income to remit more in tax than they otherwise would under the regular tax. As already discussed, about 14,000 taxpayers would not have had any individual income tax liability without the AMT in tax year 1997. On the other hand, as shown in table 2, recent research at Treasury indicated that AMT coverage, absent any legislative change, will shift from mostly higher income taxpayers in 2000 to increasingly more middle-income taxpayers by 2010.

Table 2: Distribution of Taxpayers Financially Affected by AMT and the Additional Tax Liability Generated

Adjusted gross income ^a	2000				2010			
	Number of AMT taxpayers ^b	Percentage of all taxable returns ^e	AMT liability ^c	Percentage of total AMT liability	Number of AMT taxpayers ^b	Percentage of all taxable returns ^e	AMT liability ^c	Percentage of total AMT liability
Less than \$0				0.8			0.1	0.2
\$0-\$14,999	^d	0.1	^g	0.1	^d	^f	^g	^f
\$15,000-\$29,999	^d	^f	^g	0.2	0.1	0.7	0.1	0.2
\$30,000-\$49,999	^d	0.2	^g	0.4	2.1	8.5	1.7	4.6
\$50,000-\$74,999	0.1	0.6	0.1	2.2	4.5	24.3	5.5	14.5
\$75,000-\$99,999	0.2	2.3	0.4	6.5	3.3	32.1	6.0	15.7
\$100,000-\$199,999	0.5	5.7	1.3	22.5	5.6	44.8	14.3	37.5
\$200,000 or more	0.5	20.8	3.9	67.4	1.4	45.2	10.4	27.3
Totals or overall percentages of taxpayers	1.3	1.3	5.8	100.0	17.0	15.7	38.2	100.0

Note: Totals may not sum because of rounding.

^aIn constant dollars.

^bIn millions, including reduced tax credits.

^cIn billions, including reduced tax credits.

^dLess than 50,000 taxpayers.

^eGreater than 75 percent.

^fLess than 0.05 percent.

^gLess than \$50,000

Source: Department of the Treasury, Office of Tax Analysis Working Paper 87 (June 2000).

The recent research at Treasury provided additional insight into the shift in the classes of taxpayers affected by AMT. In 2000, the projected taxpayers affected by AMT are more likely to be higher income families with many dependents. By 2010, increasingly more middle-income, moderately-sized families are expected to be affected by AMT. For example, the percentage of taxpayers affected by AMT with incomes between \$50,000 and \$75,000 and 4 personal exemptions is projected to increase from about 1 percent in 2000 to 32 percent in 2010. The primary reason for this change is that for middle-income taxpayers, personal exemptions are projected to be the largest and most common items to be added back into taxable income under AMT in 2010.

Additionally, the state of a taxpayer's residence also affects AMT coverage. The projections indicate that taxpayers living in states with high taxes are more likely to be affected by AMT than those in states with low taxes. The apparent driving factor for this change is that state and local taxes are projected to amount to about one-half of the total preference items that are added back into the taxable income for computing AMT tax liability in 2010.

Increased AMT Coverage May Affect Economic Incentives

Through its different definition of taxable income and tax rate structure, AMT may affect the economic incentives created by the regular income tax.²⁴ If AMT coverage increases over the next 10 years as projected, more taxpayers will face those affected incentives. Two examples follow.

According to JCT, AMT adjustments, preference items, and credit limitations may reduce incentives for taxpayers to undertake certain investments and activities that are favored under the regular tax. For example, unincorporated business owners' incentives to invest may be reduced because AMT rules regarding depreciation are less generous than under the regular tax. If education credits become limited by AMT because the moratorium on the use of personal credits expires, taxpayers may have less incentive to pursue educational opportunities that qualify for these credits.

Additionally, the current 26- and 28-percent tax rates under AMT are generally lower than the tax rates a taxpayer faces under the regular tax. Lower marginal tax rates—the additional tax owed from earning an additional dollar of income—decrease the disincentives taxpayers face to work additional hours or invest additional amounts.

The extent to which the incentives and disincentives affected by AMT lead to changes in taxpayer behavior and changes in overall economic performance is uncertain. For example, while AMT reduces incentives for some taxpayers to undertake certain investments and activities favored under the regular tax, it does not affect incentives for all taxpayers. As a result, AMT might affect which taxpayers undertake tax-favored activities, but might not greatly affect the total amount of tax-favored activity undertaken in the economy overall.

AMT Could Partially Neutralize Future Changes to the Regular Tax System

AMT, in its current form, could partially neutralize the impact of future legislative changes to the regular income tax system. As we mentioned previously, AMT is a parallel system to the regular income tax, but unlike the latter, it is not indexed for inflation. Thus, the impacts of any attempts to alter the regular income tax, such as cutting tax rates or adding new credits, absent corresponding changes to AMT, could be counteracted either directly or indirectly by AMT. For example, congressional proposals that would reduce taxable income in the regular income tax (such as

²⁴For discussions of the effects of AMT on economic efficiency, see Joint Committee on Taxation, *Present Law and Issues Relating to the Individual Alternative Minimum Tax ("AMT")* (JCX-3-98), Feb. 2, 1998, and Michael J. Graetz and Emil Sunley, "Minimum Taxes and Comprehensive Tax Reform," in Henry J. Aaron, Harvey Galper, and Joseph A. Pechman, eds., *Uneasy Compromise: Problems of a Hybrid Income-Consumption Tax* (Washington, D.C.: The Brookings Institution, 1988).

marriage tax penalty relief), but do not include corresponding modifications to the AMT rules, might benefit some individuals, but might also increase the number of individuals covered by AMT.

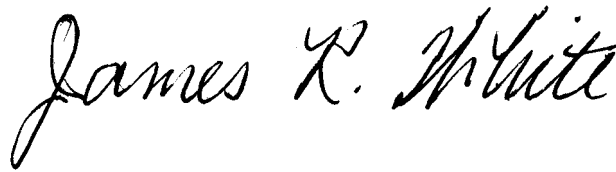
Agency Comments

On July 25, 2000, we provided a draft of this report for comment to the Secretary of the Treasury and the Commissioner of Internal Revenue. In lieu of written comments, officials from IRS' Offices of Chief Counsel and Strategic Studies verbally advised us that they agreed with the general description of AMT and suggested some technical clarifications, which we have incorporated into the report. On August 9, 2000, Treasury's Office of Tax Analysis (OTA) provided written comments on a draft of this report (see app. II). OTA officials suggested that our report be refocused to emphasize the "design" or "structural flaws" of AMT features and to analyze the extent to which the features fulfill AMT's purpose. To make such changes would require us to have developed extensive data sufficient to draw conclusions on whether or not AMT features are "design or structural flaws" and whether those features, in operation, fulfill AMT's purpose. Developing such data was outside the scope of our review, which was to provide a primer (i.e., a brief introduction) on AMT, including an overview of its rationale and impact on taxpayers. The Treasury officials also suggested a number of technical clarifications that we incorporated as appropriate.

As agreed with your office, unless you publicly announce its contents earlier, we plan no further distribution of this report until 30 days from the date of this letter. At that time, we will send copies to Senator Daniel Patrick Moynihan, Ranking Minority Member of your Committee; Representative Bill Archer, Chairman, and Representative Charles B. Rangel, Ranking Minority Member, House Committee on Ways and Means; the Honorable Lawrence H. Summers, Secretary of the Treasury; and the Honorable Charles O. Rossotti, Commissioner of Internal Revenue. We will also make copies available to others upon request.

Key contributors to this report are acknowledged in appendix III. If you have any questions, please contact me or Thomas M. Richards on (202) 512-9110.

Sincerely yours,

A handwritten signature in black ink that reads "James R. White". The signature is written in a cursive style with a large, prominent initial "J".

James R. White
Director, Tax Policy
and Administration Issues

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Abbreviations

AMT	alternative minimum tax
IRS	Internal Revenue Service
JCT	Joint Committee on Taxation

Summary of Tax Provisions Affected by AMT Rules

Tax provision	General treatment under regular tax	General treatment under AMT
Preferences under the AMT rules		
Percentage depletion ^a	Deduction equal to prescribed percent of gross income, subject to certain limitations	Excess of deduction for percentage depletion over the adjusted basis of depletable property is added to AMTI. Preference does not apply to oil and gas properties.
Intangible drilling costs ^a	Deductible currently	Amount by which excess intangible drilling costs exceed 65 percent of net income is included in AMTI. Excess intangible drilling costs are the amount that regular tax deductions exceed 10-year amortization. Preference does not apply to independent producers to extent AMTI is reduced by 40 percent or less ignoring the tax preference.
Private activity bond interest income ^a	Not included in income	Included in income if bonds issued after August 7, 1986, except for qualified section 501(c)(3) bonds issued for charitable organizations.
Depreciation or amortization on pre-1987 property ^a	ACRS depreciation allowed	Excess of regular tax depreciation over straight-line depreciation added to alternative minimum taxable income (AMTI)
Section 1202 exclusion for certain small business stock ^a	50 percent of gain on sale of stock of certain small businesses excluded from income	42 percent of the gain excluded from regular tax is included in AMTI.
Adjustments under the AMT rules		
Standard deduction	Fixed amount deductible, depending on filing status. Amounts are indexed for inflation	Disallowed
Itemized deductions ^b		
State and local property (real and personal) and income taxes	Fully deductible	Disallowed
Medical expenses	Allowed to the extent that they exceed 7.5 percent of a taxpayers AGI	Allowed to the extent that they exceed 10 percent of a taxpayers AGI
Miscellaneous expenses	Deductible to the extent total exceeds 2 percent of AGI	Disallowed
Home mortgage interest ^a	Qualified residence interest, including interest on home equity loans, is deductible (subject to certain limits)	Qualified housing interest is deductible; interest on a home mortgage not used to buy, build, or improve a home is not deductible
Investment interest expense ^a	Deductible to the extent of investment income	Difference between interest deduction for regular tax and interest deduction calculated under AMT rules is added to AMTI (can be positive or negative)
State income tax refund	Included in taxable income if deducted in previous year	Deducted if included in calculation of regular taxable income
Personal exemptions	Fixed amount per dependent is deducted from income. Amount is indexed for inflation and subject to phase-outs based on taxpayer income	Disallowed
Depreciation of post-1986 property (real and personal) ^a	Accelerated cost recovery system using prescribed recovery periods and 200% declining balance method for 3, 5, 7, and 10 year classes	Depreciation is recalculated and difference between regular tax depreciation and AMT depreciation is added to AMTI. For property placed in service after 1986 and before 1/1/99, alternative depreciation system class lives (generally longer) and 150% declining balance method (generally slower) is used. For property placed in service after 12/31/98, regular tax lives are used.

Appendix I
Summary of Tax Provisions Affected by AMT Rules

Tax provision	General treatment under regular tax	General treatment under AMT
Mining exploration and development costs ^a	Deductible currently	10-year amortization
Amortization deduction for pollution control facilities ^a	60-month amortization	Amortization is recalculated and the difference between regular tax depreciation and AMT depreciation is added to AMTI. For facilities placed in service before 1/1/99, alternative depreciation system (generally longer lives and straight-line method) is used. For facilities placed in service after 12/31/98, regular tax lives and straight-line method is used.
Circulation expenditures ^a	Deductible currently	3-year amortization
Research and experimental expenditures ^a	Certain expenditures deductible currently	10-year amortization
Incentive stock options ^a	No income on the exercise of option; option price is basis for future gain or loss	Income on exercise equal to excess of fair market value over option price; fair market value is basis for future gain or loss
Adjusted gain or loss	Gain or loss on sale of asset calculated using regular tax basis	Gain or loss calculated using AMT basis
Losses	Deductibility limited by at-risk and passive activity loss rules	Losses from tax shelter farm or passive activities are limited
Net operating loss deduction ^a	Can offset 100 percent of taxable income	Limited to 90 percent of alternative taxable income
Foreign tax credit	Can offset 100 percent of tax liability on foreign source income	Limited to 90 percent of pre-credit AMT liability calculated without regard to net operating losses
Earned income credit	Refundable—credit claimed can exceed regular tax liability	Reduced by the amount the taxpayers tentative minimum tax exceeds regular tax liability
General business credit	Combination of a number of tax credits; cannot reduce current-year regular tax below 25 percent of net regular tax liability that exceeds \$25,000	Cannot reduce regular tax liability below tentative AMT liability
AMT credit	Prior-year AMT liability from deferral adjustments and preferences can be claimed	Prior-year AMT liability cannot reduce current-year AMT liability

^aUse of this tax provision automatically requires a taxpayer to compute an AMT tax liability as depicted in Step 2 of the AMT process (see fig. 1 on p. 5). The worksheet also instructs taxpayers with AMT adjustments from an estate, trust, electing large partnership or a cooperative to complete the AMT form.

^bCertain itemized deductions are subject to phase-outs based on taxpayer income.

Source: GAO analysis of Internal Revenue Code.

Comments From the Department of the Treasury

Note: GAO comments supplementing those in the report text appear at the end of this appendix.



DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

August 9, 2000

Mr. James R. White
Director, Tax Policy and Administration Issues
General Government Division
United States General Accounting Office
Washington, DC 20548

Dear Mr. White:

Thank you for providing the Department of the Treasury with an opportunity to comment on the draft of your report entitled "Alternative Minimum Tax: An Overview of Its Rationale and Impact on Individual Taxpayers." Our general comments are provided below. Specific comments are provided in the enclosure.

See comment 1.

We suggest that, through some modest changes in wording, the emphasis of the report be placed on "design flaws" or "structural flaws" in the Alternative Minimum Tax (AMT) and that the discussion of AMT features such as the lack of inflation indexing be discussed in that context. Generally, it is the interaction of various structural features of the AMT that produces problems. For example, if the structure of the AMT reflected family size, the lack of indexing might be of less immediate concern. Moreover, in discussing the lack of indexing of the various AMT parameters, we suggest that your report emphasize that the problem is not caused by lack of AMT indexing *per se*; rather, the problem stems from the interaction of the unindexed AMT with the indexed ordinary tax system.

See p. 19.

See p. 11.

In discussing the various elements of the AMT, we suggest that the report attempt to relate each AMT preference or adjustment item to the purpose of the AMT, that is, assuring that high-income people pay at least some income tax. The report should discuss the importance of those items when the AMT affects only a small number of high income individuals and when, as it does currently, the AMT may affect larger numbers of taxpayers including those with more modest incomes. For example, if the AMT affected only taxpayers at income levels at which the deductions for personal exemptions were fully phased out under the ordinary income tax (over \$283,650 on joint returns for tax year 2000), the lack of an adjustment for family size would have little, if any, significance.

See p. 19

When discussing the special AMT provisions for married taxpayers filing separate tax returns, it would be helpful to place those provisions in the context of the many other special Internal Revenue Code provisions for married taxpayers filing separately. Such provisions have generally been included to minimize or prevent taxpayers who have the ability to allocate income arbitrarily

See comment 2.

Appendix II
Comments From the Department of the Treasury

2

between spouses from reducing their tax liabilities relative to otherwise similarly-situated taxpayers who cannot allocate income as they choose—for example, because their income primarily arises from wages.

See comment 3.

Beginning on page 4, the draft report includes an extended description of the steps that taxpayers must take in calculating their ordinary tax, deciding whether they must consider the AMT, calculating possible reductions in tax credits due to the AMT, and calculating actual AMT liability. Taxpayers do not actually compare the difference between their regular tax liability (before most credits) and their tentative AMT and pay the higher of the two. They determine their regular tax liability (before most credits), calculate their tentative AMT, and if tentative AMT is greater than regular tax liability, they add the difference between tentative AMT and regular tax liability to their regular tax liability and pay that amount. The tax paid is exactly the same as described in the GAO report, but the actual procedure is a little more complicated than described. In particular, taxpayers are required to perform worksheet calculations, tax credit by tax credit, in a given order to determine the extent, if any, to which each tax credit must be reduced because of the AMT. Those credit reduction calculations do not seem to be reflected in the draft report's description.

See comment 4.

The paper by Rebelein and Tempalski (2000) that is referenced in the GAO report is an OTA Working Paper by two economists with the Department of the Treasury. The paper should not be referred to as either a "Treasury study" or "Treasury research," because it does not necessarily represent the views or position of the Treasury Department (as indicated in the disclaimer on the front page of the paper). Rather, the citations should be to the authors or to the working paper.

See comment 5.

The draft report relies heavily on dollar amounts presented in the paper by Rebelein and Tempalski (2000). The draft report, however, does not always describe those amounts accurately. Most of the dollar amounts presented in Rebelein and Tempalski are tax "liabilities." The draft GAO report sometimes describes these amounts as "revenues" or "receipts" rather than "liabilities." The terms "revenues" (or "receipts") and "liabilities" have different meanings. Revenues (or receipts) refer to the government's receipt of a taxpayer's payment of actual or estimated liability. Generally, only a portion of liability incurred in a given year produces revenues or receipts for the government in that same year; some portion of the liability is generally not received by the government until the following year. Only Table 2 in Rebelein and Tempalski (2000) contains revenue estimates; all other tables contain liability estimates.

See comment 6.

The draft report generally uses the term "AMT liability" to describe the item that is described on the AMT form as "tentative minimum tax." On the AMT form, "tentative minimum tax" is compared with a taxpayer's regular tax liability (before most credits) to determine the additional liability as calculated on the AMT form. The draft report's use of the term "AMT liability" improperly suggests that tentative minimum tax is the amount of liability a taxpayer incurs because of the AMT. The report should make the appropriate changes to incorporate the use of the term "tentative minimum tax" or "tentative AMT" (for brevity) consistently in the report.

Appendix II
Comments From the Department of the Treasury

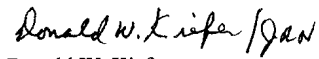
3

See comment 7.

The report incorrectly uses several numbers from the Rebelein and Tempalski paper. (See enclosure for specific examples.) GAO should review all numbers in the text and tables for accuracy (we have not checked all of them).

If you have questions about our comments on this study, please feel free to contact Allen Lerman at 622-1325 or Jerry Tempalski at 622-0275 (both are economists in the Office of Tax Analysis). If you would like to discuss future GAO reports on tax issues at the planning or pre-circulation stage, please contact me at 622-0269.

Sincerely,



Donald W. Kiefer
Director, Office of Tax Analysis

Enclosure

The following are GAO's comments on the August 9, 2000, letter from the Department of the Treasury's Office of Tax Analysis (OTA).

GAO's Comments

1. OTA's letter included an enclosure containing technical comments. We did not reproduce the enclosure, but we incorporated the technical comments as appropriate.

2. As OTA suggested, we expanded the discussion of AMT for married taxpayers to include a description of the rationale for limitations on taxpayers filing separately under both the regular tax and AMT.

3. OTA suggested that our description of the steps that taxpayers must undertake to determine their regular tax and AMT liabilities are more complicated than we describe. It also stated that taxpayers do not actually compare the difference between their regular tax liability (before most credits) and their tentative AMT and pay the higher of the two. However, later on in its letter, OTA states that "On the AMT form, tentative minimum tax is compared with a taxpayer's regular tax liability (before most credits) to determine the additional tax liability." As OTA suggested, taxpayers calculate their regular tax liability, calculate their tentative AMT, and if their tentative AMT liability is greater, they add the difference to their regular tax liability and pay this amount. In effect, this amount is equal to their tentative AMT and, as such, taxpayers are paying the greater of their regular tax and AMT as we described. While we provided a generalized description of this process, it is essentially the same as OTA described, and they agreed that "the tax paid is exactly the same as described in GAO's report." Given that the purpose of the report is to provide a primer (i.e., a brief introduction) on AMT, we made no adjustment.

4. OTA commented that OTA Working Paper 87 (June 2000), which we used as a source for data estimates on the impact of AMT, should not be referred to as a Treasury study or Treasury research. OTA made this comment because the views expressed in the report do not necessarily represent the views of the Treasury Department as indicated by a disclaimer printed on the report. During the course of our review, responsible OTA officials assured us that we could refer to the data published in the OTA Working Paper as "recent research by Treasury." This was possible because all estimates contained in the report were made using the Treasury Department's Individual Tax Model in combination with the administration's economic forecast from the fiscal year 2001 budget. Accordingly, we cited the data from the report but not the views expressed by the authors. Thus, we believe that it is appropriate to characterize the working paper's data estimates as Treasury research. However, in

response to OTA's written comments, we revised the report to clearly acknowledge the disclaimer and refer to the estimates as "recent research at Treasury."

5. As suggested by OTA, the report was revised to distinguish more clearly between AMT liability and revenue where appropriate.

6. OTA commented that we should describe the liability from the AMT tax calculation as the tentative AMT and indicate that the AMT liability is the difference between the tentative AMT and the regular tax. This comment is essentially the same comment as we discussed in comment 3. As we explained in comment 3, the bottomline of these calculations is that taxpayers are liable for paying the greater of the tax computed under the AMT rules or the regular tax rules. Given that our report provides a generalized description of AMT, we made no adjustment, that is, we refer to the tax computed under AMT rules as an AMT liability.

7. As OTA suggested, we adjusted line 8 of table 2 to account for the collapsing of data into one stratum.

GAO Contacts and Staff Acknowledgments

GAO Contacts

James R. White, (202) 512-9110
Thomas M. Richards, (202) 512-9110

Acknowledgments

In addition to those named above, Daniel Lynch, Ed Nannenhorn, Anne Stevens, and Cheryl Peterson made key contributions to this report.

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