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Seek Ways to Minimize the Mushrooming Alternative Minimum Tax

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Abstract:

The AMT, the “stealth bomber” of the tax law, has evolved from a backstop to prevent tax avoidance by the wealthy to an often-unanticipated extra tax on the middle class. The alternative minimum tax (AMT) is reaching a broader segment of individuals. Yet, many of these taxpayers are not aware of the implications of this tax. Even worse, some of their tax advisors are not as informed as they should be. By identifying items that trigger the individual AMT, taxpayers and their advisors have greater opportunities to develop strategies to avoid the special tax. The AMT is essentially a parallel tax system that involves a separate tax calculation from the regular income tax. The AMT calculation is then compared to the income tax figured under the normal manner. The taxpayer pays the higher of the two amounts. With proper planning, many individuals can avoid or at least reduce their AMT liability. For best results, these individuals should enlist the aid of a tax

professional to perform pro forma calculations throughout the year and identify the AMT potential of transactions sufficiently in advance for the taxpayer to plan accordingly. In instances where the AMT-producing transaction is still worthwhile, the taxpayer can take steps to raise the necessary cash to pay the tax.

The alternative minimum tax (AMT) is reaching a broader segment of individuals. Yet, many of these taxpayers are not aware of the implications of this tax. Even worse, some of their tax advisors are not as informed as they should be. By identifying items that trigger the individual AMT, taxpayers and their advisors have greater opportunities to develop strategies to avoid the special tax.

History of the AMT

Congress has shaped the tax law to achieve a number of objectives. In addition to revenue raising, tax laws have economic, social, equity, and political considerations. Congress became concerned that many wealthy taxpayers and corporations were taking undo advantages of certain deductions provided in the tax law to reduce, if not entirely escape, taxation. Beginning in 1969, Congress introduced new rules to ensure that all very wealthy individuals would pay at least some tax. As a consequence, what is now the AMT was created. The AMT applies to both individuals and corporations. The focus of this article is the AMT for individual taxpayers. The statutory provisions of the AMT are contained in Sections 55 through 59, and the AMT is computed on Form 6251.

The AMT is essentially a parallel tax system that involves a separate tax calculation from the regular income tax. The AMT calculation is then compared to the income tax figured under the normal manner. The taxpayer pays the higher of the two amounts (or, more technically, pays the regular tax plus the excess of the AMT over the regular tax¹).

Over the years, the number of income and deduction items that receive "special" treatment in computing the AMT has increased. When this is combined with the fact that individual tax rates were lowered in 2001 and 2003 while AMT tax rates and exemption amounts have not

been indexed for inflation, the impact of the AMT has mushroomed. "This year, more than 3 million taxpayers-most of them middle-class and upper-middle class couples with kids-are going to get clobbered by the tax."² In her annual report to Congress on 12/31/03, Nina Olsen, the taxpayer advocate at the IRS, identified the AMT as the biggest problem taxpayers face today. A study published by the Urban-Brookings Tax Policy Center projects that by 2010, one-third of all individual income taxpayers will be subject to the AMT.³ Many of these taxpayers will have taxable incomes of between \$50,000 and \$100,000, which means that a growing number of middle- to upper-middle-class people will be subject to the AMT.

Among those affected by the AMT are taxpayers in the first few years of their retirement because they tend to have more long-term capital gains and deductions relative to their ordinary income.⁴ Many of these taxpayers are people that Congress had never intended to affect when the forerunner of the AMT was introduced in 1969.

Computation of the tax

The AMT is separate from, but parallel to, the regular tax system.⁵ The process for calculating the AMT on Form 6251 is as follows:

- Taxable income under the regular system
- + or - Adjustments
- + Tax preferences
- = Alternative minimum taxable income (AMTI)
- Exemption amount
- = Alternative minimum tax base (AMTB)
- x 26% of the first \$175,000 of AMTB plus 28% of the excess of AMTB over \$175,000
- = Tentative minimum tax
- Tax liability on taxable income using the normal income tax rates
- = AMT (assuming this amount is positive)

The taxpayer then owes the AMT in addition to the regular tax. The net effect of this is that the taxpayer pays the higher of the

tentative minimum tax or the tax liability on taxable income computed in the normal manner on Form 1040.

Adjustments

Adjustments include items such as depreciation expense on business real property and business personal property (machinery and equipment).⁶ Depreciation expense for these properties is computed in a different manner for AMT purposes, and the different depreciation amounts are netted and result in an addition to or subtraction from taxable income.

Another major adjustment item involves incentive stock options. Many companies use incentive stock options as part of the compensation arrangement to attract and retain important employees. Stock options give one the right (but not the obligation) to buy company stock at a fixed (strike or exercise) price for a certain number of years. Exercise of the option has no impact on the employee's taxable income.⁷ The taxable compensation is reported only when the stock is sold. If the stock is held for over one year after purchase and two years after being granted the option, the proceeds qualify as long-term capital gains rather than ordinary income and, as such, are taxed more favorably.⁸ Most long-term capital gains of an individual taxpayer are eligible for a special 15% tax rate (or a 5% tax rate for taxpayers in the 10% or 15% tax bracket) while ordinary income items are taxed at the taxpayer's marginal rate (35%, 33%, 28%, 25%, 15%, or 10%).⁹

These options receive a different tax treatment for AMT purposes. If the options are exercised, the difference between the current market value of the stock and the exercise price, known as the spread, or bargain (or intrinsic value of the option), is a positive adjustment for AMT purposes unless the stock is sold in the same year (in which event it would be taxed at the higher regular income tax rate).¹⁰ Thus, the AMT makes the strategy of exercising incentive stock options and holding the stock less favorable.

Positive adjustments to taxable income are also made for personal and dependency exemptions that are not allowed in

computing the AMT.¹¹ Those who claim the standard deduction must also add this to taxable income for AMT purposes.

Taxpayers who itemize their deductions lose the benefit of deductions for such items as state and local income and property taxes, home equity loan mortgage interest, and certain miscellaneous itemized deductions in computing the AMT.¹² This makes people who live in high tax states much more vulnerable to the AMT. Also, medical expenses are deductible for AMT purposes only to the extent the expenses exceed 10% of adjusted gross income, rather than the 7.5% of adjusted gross income threshold that applies for regular income tax purposes.¹³

Preference items

Taxable income is also increased by tax preference items. Tax preferences include income exclusions and deductions that provide large tax savings. One example of a tax preference item involves interest income on certain private activity bonds. Private activity bonds are state and local governmental obligations that are issued to finance a nongovernmental (private) business, such as a new sports facility or an industrial park. While such interest income is exempt from federal taxation, interest income on private activity bonds is a preference item for AMT purposes.¹⁴

Other prominent tax preference items are the excess of accelerated depreciation over straight-line depreciation on real property placed into service prior to 1987 and percentage depletion in excess of the natural resource's adjusted basis. See Exhibit 1 for a summary of the common AMT adjustments and preferences items.

Exemption amounts

To prevent taxpayers with small amounts of positive adjustments and tax preferences from being subject to the AMT, AMTI is reduced by an exemption amount. Under current law, the exemption amounts, increased by The Jobs and Growth Tax Relief Reconciliation Act of 2003, are \$58,000 for married taxpayers filing jointly, \$40,250

for single taxpayers, and \$29,000 for married taxpayers filing separately.¹⁵ However, these exemption amounts are phased out at the rate of 25 cents on the dollar when AMTI exceeds \$150,000 for married taxpayers filing jointly, \$112,500 for single taxpayers, and \$75,000 for married taxpayers filing separately.

The increased exemption amounts were to expire at the end of 2004. However, in late 2004, Congress passed (and President Bush signed) the Working Families Tax Relief Act of 2004 that extended the AMT exemption amounts through 2005.

(See Appendix for Illustration)

Planning strategies

Given the reality of the AMT, affected taxpayers should focus on reducing or eliminating AMT positive adjustments to taxable income and tax preference items. Moreover, any expenses that are deductible for normal tax purposes but not for AMT purposes, should be minimized to the extent possible.

Taxpayers cannot, of course, reduce the number of children in the family or the income taxes and real property taxes levied by the state in which they live. These are the most common items that trigger the AMT. The subtraction of personal and dependency exemptions, along with state income and local real property taxes, and home equity loan interest, which are deductible for normal income tax purposes (assuming the taxpayer can itemize), are not allowed under the AMT calculations.

A point to consider for those taxpayers subject to the AMT who have dependents earning a modest taxable income (through dividends, interest, and work from a part-time job) would be to arrange things so that the individual does *not* qualify as a dependent. This would allow the person (e.g., a child attending college) to claim his or her own personal exemption.¹⁷

Also, when deciding in which state to live (for retirement purposes or if one lives near a state border and would have similar

commuting costs living in either state), taxpayers should calculate the "true" cost of the state and local taxes paid. This cost determination should take into account that the taxes are not deductible for AMT purposes.

Renting real property, rather than ownership, would eliminate real property taxes and home equity loan interest expense. This strategy, applied to people living in states with low individual income tax rates would reduce or eliminate both the state real property tax expense and the state income tax expense. Of course, renting rather than owning would forsake the potential for capital appreciation if the value of the real estate should increase. For those who prefer ownership, pro forma tax planning calculations should identify the higher total tax caused by the AMT in advance to allow the taxpayer to prepare to pay the larger amount.

As identified earlier, one of the most common positive adjustments under the AMT involves the exercise of an incentive stock option. An efficient tax planning strategy would consider spreading the exercise of incentive stock options over multiple years to offset the large adjustment that would arise if all of the options were exercised in one year.

Another positive adjustment tax preference item to taxable income under the AMT computation is accelerated depreciation. Any excess depreciation (above straight-line depreciation) taken on property must be included in the AMT calculation. Thus, one may want to choose straight-line depreciation because the AMT would eliminate the benefit of using an accelerated depreciation method. Long-term capital gains can also cause an individual to owe AMT. This is often overlooked because the top tax rate on capital gains is the same 15% (5% for those in tax brackets below 25%) rate as for regular tax purposes.¹⁸ The presence of capital gains, however, raises the taxpayer's income for purposes of phasing out the AMT exemption amount. Thus, the true tax cost of the capital gains can exceed the stated 15% (or 5%) rate. Taxpayers should consider this effect when timing their dispositions of appreciated property.

Conclusion

The alternative minimum tax is a powerful but complicated provision of the individual income taxation law. Those who are subject to the provisions of the AMT can find staggering increases in their income tax liability.

With proper planning, many individuals can avoid or at least reduce their AMT liability. For best results, these individuals should enlist the aid of a tax professional to perform pro forma calculations throughout the year and identify the AMT potential of transactions sufficiently in advance for the taxpayer to plan accordingly. In instances where the AMT-producing transaction is still worthwhile, the taxpayer can take steps to raise the necessary cash to pay the tax.

Notes

¹ Section 55(a).

² Gleckman "The Stealth Tax," *Business Week*, 2/16/04, page 87.

³ Burman, Gale, Rohaly, and Harris, "The Individual AMT: Problems and Potential Solutions," Urban-Brookings Tax Policy Center, Discussion Paper No.5, 9/18/02.

⁴ Hube, "Tax trap: More retirees are getting hit with the dreaded alternative minimum tax; here's how to soften the blow," *Wall St. J.*, 9/30/02, page R5.

⁵ Joint Economic Committee Study, U.S. Congress, "The Alternative Minimum Tax for Individuals: A Growing Burden," May 2001.

⁶ Section 56(a)(1).

⁷ Section 421 (a).

⁸ Section 422(a).

⁹ Sections 1(h) and (i).

¹⁰ Section 56(b)(3).

¹¹ Section 56(b)(1)(E).

¹² Section 56(b)(1).

¹³ Section 56(b)(1)(B).

¹⁴ Feldman, Amy, "The tax of unintended consequences," *32 Money* 86 (September 2003).

¹⁵ Section 55(d).

¹⁶ Adapted from West's Federal Taxation: Corporations, Partnerships, Estates & Trusts, 2005 Edition, Thomson South-Western Publishing Co.

¹⁷ See Section 152 for the tests to qualify as a dependent.

¹⁸ Section 55(b)(3).

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Appendix

Exhibit 1

Common adjustment and tax preference items in computing the AMT

(For details, see Sections 55 and 56.)

- Standard deduction.
- Exemptions.
- Medical and dental expenses.
- State and local taxes.
- Home equity loan interest.
- Miscellaneous itemized deductions.
- Refund of taxes.
- Investment interest.
- Post-1988 depreciation.
- Adjusted gain or loss.
- Incentive stock options.
- Passive activities.
- Beneficiaries of estates and trusts.
- Tax-exempt interest from private activity bonds issued after 8/7/86.

Illustration

A single individual has the following items for 2005:¹⁶

Salary	\$141,000
Interest income from bank savings account	12,000
Interest income from corporate bonds	7,000
Short-term capital gain from sale of stock	8,000
Itemized deductions:	
Unreimbursed employee expenses (no meals or entertainment) in excess of 2% x AGI	640
Medical expenses in excess of 7.5% x AGI	11,400
State income taxes	6,500
Real property taxes	6,800
Home mortgage interest	7,200
Tax preferences	116,000
Adjusted gross income (\$141,000 + \$12,000 + \$7,000 + \$8,000)	\$168,000
Less: Itemized deductions (See Note 1)	31,871
Personal exemptions (See Note 2)	_____ 2,418
Taxable income	\$133,801
2005 income tax liability	\$31,971

Note 1. Because taxpayer's AGI exceeds \$142,700, itemized deductions are subject to a cutback adjustment.

Note 2. Because taxpayer's AGI exceeds \$142,700, the personal exemption is subject to a phase out.

The taxpayer's AMT as computed on Form 6251 is:

Taxable income	\$133,801
Plus: Adjustments and preferences	
Tax preferences	116,000
Personal exemption	2,418
Itemized deductions disallowed (See Note 3)	17,381
Less: Itemized deduction cutback adjustment (See Note 4)	_____ 759
Alternative minimum taxable income	\$268,841
Less: Exemption (subject to partial phase out) (See Note 5)	_____ 1,165
AMT base	\$267,676
Tentative AMT (See Note 6)	\$71,449
Less: Regular income tax liability as computed on Form 1040	_____ 32,091
Alternative minimum tax	\$39,358

Note 3. Itemized deductions allowed for AMT are \$7,200 mortgage interest and \$7,200 of medical expenses.

Note 4. 3% of excess of AGI (\$168,000) over threshold amount (\$142,700).

Note 5. AMT exemption for single taxpayer (\$40,250) less phase out of \$39,085 [(\$268,841 - \$112,500) x 25%].

Note 6. $\$175,000 \times 26\% + (\$267,676 - \$175,000) \times 28\%$.

Thus, as a result of the AMT, the taxpayer owes \$71,449, which is more than twice the income tax liability computed in the normal matter. This illustration shows not only the tax burden caused by the AMT, but the additional complexity in its computation.

Planning Tip

- Life insurance policies have a tax advantage for individuals subject to the AMT. The inside investment buildup of an insurance policy is not subject to current tax under either the regular income tax or AMT systems. Life insurance policies are available with a variety of features that improve their appeal to investors. For instance, variable universal life insurance is a fairly

common financial product. When evaluating the attractiveness of an insurance policy as an investment vehicle, however, consider how fees associated with the policy may offset or mitigate any positive tax effects.