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ALTERNATIVE MINIMUM TAX (AMT)

What is it? The Alternative Minimum Tax (AMT) is not an alternative. Nor does it minimize taxes. Very simply, it is a second tax calculation that eliminates some deductions, minimizes others, and frustrates all that are affected by it.

According to the former IRS Commissioner, Charles O Rossotti, in his book Many Unhappy Returns, the AMT was originally enacted in 1969 after Congress discovered that 155 people with incomes over $200,000 in 1966 paid zero income tax. Originally, the AMT was instituted to make sure that very high-income individuals paid some minimum tax despite their deductions.

The Internal Revenue Code was completely overhauled with the Tax Reform Act of 1986. While much of the tax code, such as AGI phaseouts, exemptions, standard deductions and taxable income amounts are increased each year for inflation or the cost of living, AMT was not until the 2012 tax year. Congress finally allowed the AMT exemptions and taxable limits to be indexed by inflation. However, a family that was not even considered by Congress for the AMT in 1969, or even in 1986, might be adversely affected simply due to the rise of literal income and deductions since that time.

It is estimated that the states with taxpayers affected the most by AMT are California, New York, and Massachusetts. These states, though not exclusive, have high property taxes and state income taxes. As you will note on the following pages, these two items are not deductible for AMT and thus subject many to AMT due to this one adjustment.

Rather than highlighting the problems of the AMT or the numerous suggestions to reduce or eliminate the AMT, the next few pages attempt to explain what it is now and how it is calculated. Two Tylenol and a tall glass of water (or other liquid with a higher proof) are recommended for your reading pleasure. Often understanding the principles behind the tax takes away much of the mystery of the AMT tax.

What is not affected? Most municipal interest is not subject to AMT. As well, long-term capital gains and qualified dividends for the most part are taxed at the same rates as they would be for regular tax.

<u>Am I affected?</u> Maybe. To find out if AMT affected you in 2012, please check line 45 on page two of your Form 1040. If there is an amount, you may review the attached Form 6251 to see how you were affected.

After reviewing the next few pages you may conclude that AMT sends the following messages:

1) Having children is not good for tax purposes; dependents are not deductible
2) Paying state income tax and property taxes is not good; they are not deductible for AMT
3) Paying taxes on interest, dividends, and capital gains is good, but the tax advisory fees and portfolio fees to earn that income are not good; they are not deductible for AMT
4) Paying taxes on wages is good, but it is not good to incur necessary employee business expenses to earn those wages; they are not deductible for AMT
5) My tax preparer does not charge me nearly enough for Form 6251; definitely not good!

<u>How is it calculated?</u> Simply put, your regular taxable income before exemptions (line 41 of page two of the Form 1040) plus or minus the AMT adjustments and AMT preferences results in AMTI, or Alternative Minimum Taxable Income. This AMTI minus a standard AMT exemption (which has phase outs) multiplied by the AMT tax rate (there are two tax rates), less Foreign Tax and other tax credits gets us our tentative minimum tax. If that minimum tax exceeds the regular tax (line 44 on page two of the Form 1040), the difference, or increase, is the true Alternative Minimum Tax (AMT). Huh!?! Let's try that again……..

The following explains the detail of the AMT process:

1) **Start** with taxable income **before** exemptions (line 41 of page two of Form 1040). With regular tax a personal exemption of over $3900 (for 2013) for each dependent is given. A family of 5 would get more than a $19,500 exemption. This is eliminated for AMT purposes. Sorry, while children give us benefits such as patience, endurance, and a sense of humor, they do not give us an AMT break.
2) **Add** all state, local, and property taxes paid (line 9 of Schedule A). Yes, that is right. The high state income taxes, property taxes, and DMV fees that are normally deductible and give you a break for regular tax, don't for AMT. This is why Federal lawmakers from California, New York, Oregon, and Massachusetts don't like the AMT. They all have constituents who live in a high income tax state with rising real property values and property taxes thus subjecting them to AMT.
3) **Add** some home mortgage interest deductions. Under regular tax, you may deduct the interest on the first $1 million of your mortgage if it was used to purchase, improve or acquire your home. In addition, you may deduct interest on an additional $100,000 of debt against your home for non-acquisition purposes (pay off credit card debt, car loans, etc). The interest on this home equity, or non-acquisition, non-purchase, non-improvement debt is not deductible for AMT.

4) **Add** all miscellaneous deductions subject to 2% of your AGI (line 27 of Schedule A). Yes, for AMT, tax preparation fees, union dues, employee business expenses, safe deposit box fees, investment advisory fees, estate tax planning fees, etc are not deductible for AMT. So, many of the expenses that allowed you to earn income such as dividends, interest, and wages are not deductible for AMT.
5) **Deduct** (finally an adjustment that helps reduce AMT) any amount of itemized deductions that were phased out for regular tax purposes. With the regular tax, as your AGI exceeds $300,000, your itemized deductions are slowly phased out. There is no phase out of itemized deductions for AMT.
6) **Deduct** any taxable state tax refunds listed on page one, line 10 of the Form 1040. The reasoning is this, if you can't deduct state income taxes for AMT, why should you have to pay taxes on the state tax refunds you get. This actually makes sense.
7) **Add** interest earned from specified private activity bonds. These bonds are considered municipal interest income for regular tax purposes and are not taxable. However, these specific private activity bonds (your brokerage firm will tell you if you own any) are taxable for AMT. However, you may **deduct** investment interest expense not allowable for regular tax since you now have more investment interest income for AMT.
8) **Add or deduct** for depreciation adjustments. Many assets purchased in a business are depreciated using an accelerated method (200% declining balance) for regular tax. However, for AMT, only a 150% DB may be used. For AMT, this means the asset will still be fully depreciated but at a slower pace for a longer period of time. This will result in an addition to AMTI for the earlier years of the asset and a deduction in latter years.
9) **Add** the bargain element of an exercised incentive stock option (ISO) for AMT. If your company has a qualified stock option plan for employees, this will have no effect for regular tax, but will for AMT. For example, you receive an ISO to purchase 1,000 shares of your employer's stock for $50/share. You exercise your option when the fair market value of the stock is $70/share. For regular tax purposes there is no gain and you have a basis of $50/share. For AMT purposes, you have to add $20,000 (1,000 shares times bargain element, $20) to AMT income. Your basis is $70/share for AMT.
10) **Add or deduct** the difference on a sale of an asset. For points #9 and #10, you may have a different basis for regular tax than for AMT. Since depreciation methods are different for regular tax and AMT, the basis of an asset is different for regular tax and AMT. As well, your gain on that ISO will be smaller for AMT than for regular tax.
11) **Add or deduct** for numerous other adjustments that affect very few taxpayers. This is just an overview of some of the adjustments.
12) **Total.** By adding or subtracting from regular taxable income before exemptions, we get the Alternative Minimum Taxable Income (AMTI).
13) **Deduct** the AMT exemption. For 2013, the exemption is $80,800 if married and $51,900 if single. This exemption is phased out. For every dollar that AGI exceeds $153,900 if married and $115,400 if filing as single, 25% of the exemption is phased out.

14) **Multiply** the AMTI less the exemption by 26% on the first $179,500 and by 28% for amounts exceeding $179,500 (2013 figures).
15) **Deduct** any minimum foreign tax credit.
16) **Total. This is the tentative minimum tax.** Compare this figure with the total regular tax (Page two of Form 1040, line 43). If the AMT exceeds the regular tax, you pay the AMT. If the regular tax exceeds the AMT, then you pay the regular tax.

How can I avoid AMT? How are those two Tylenol doing? The most common question that is asked is: “How can I avoid the AMT?” The answers are not very encouraging. Simply put, if taxpayers find themselves with AMT most every year, not much can be done. However, if a taxpayer finds that only a particular year will be affected by AMT, they may do some planning. For example, state income taxes or property taxes may be postponed to a year with no AMT.

Conclusion. The Alternative Minimum Tax is neither an alternative, nor minimizing, it is simply another tax. Some have likened trying to understand the AMT as simple as hugging air; it is hard to grasp. More than not, this is an elusive and frustrating task. However, the above generally describes how most taxpayers are affected by the AMT. Understanding how it works will not eliminate the frustration, but it will help you understand why many are becoming subject to AMT for the first time.