

The Alternative Minimum Tax: Coming to a Tax Return Near You

By Mark H. Gaudet

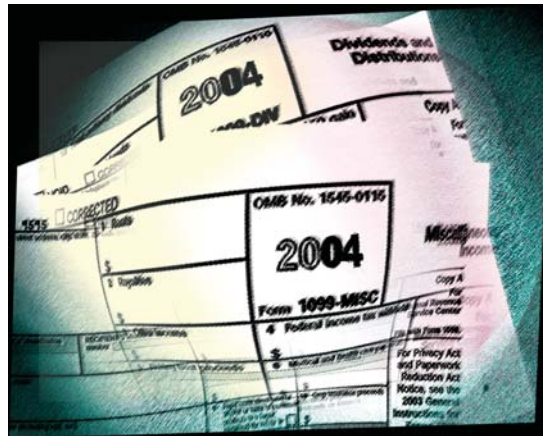
Thirty-five years have passed since the introduction of a minimum tax system in the United States. Yet it has never hit as many taxpayers as it does today.

According to a recent study by the Congressional Budget Office, the alternative minimum tax (AMT) is expected to affect about 20% of all taxpayers by the year 2010. In contrast, the study found that less than 1% of all taxpayers were subject to AMT in any year prior to 2000.

The current individual income tax system in the United States consists of two parallel tax systems: the regular tax, and the AMT. The primary purpose of the AMT system is to keep taxpayers with high incomes from paying little or no income tax by taking advantage of various deductions, exclusions and credits to the regular tax found in the Internal Revenue Code.

However, it is clear that the AMT system is starting to reach down into the lower levels of income. And that has many taxpayers asking: Will it reach me?

In this article, I'll give a brief history of the AMT system and then discuss items that may cause you to become subject to the AMT. I'll conclude with a few planning tips that will help you to reduce your possible exposure to the AMT in the coming years.



Where It Started

The first minimum tax was introduced with the passage of the Tax Reform Act of 1969. The original tax was an add-on minimum income tax of 10% on certain tax preference items that exceeded an exemption amount of \$30,000.

The Revenue Act of 1978 established an alternative minimum tax that was in addition to the minimum income tax.

In 1982, Congress repealed the add-on minimum tax system and made the AMT tax rate a flat 20% of AMT income after exemptions.

The Tax Reform Act of 1986 made significant changes to the AMT system, including the phase-out of the AMT exemption for high-income taxpayers, an increase in the number of AMT preference items and the introduction of an income tax credit for prior-year AMT liabilities.

The fundamentals of AMT have remained basically unchanged since 1986. However, in 1993 the graduated AMT rates of 26% and 28% were enacted. In addition, the AMT exemption was increased to \$33,750 for single taxpayers and \$45,000 for married taxpayers filing a joint return.

Most recently, there was a temporary increase in the AMT exemption amount for all taxpayers for the 2003–2005 tax years. After 2005, however, that temporary increase will

Table 1. AMT Exemption Amounts

AMT Exemption Amounts for 2003 Through 2005			
Filing Status	Maximum Exemption	Exemption Phase-Out	
		Reduced by 25% of AMTI Over:	Total Phase-Out at AMTI Over:
Single or Head of Household	\$40,250	\$112,500	\$273,500
Married Filing Joint or Qualified Widower	\$58,000	\$150,000	\$382,000
Married Filing Separate	\$29,000	\$75,000	\$191,000

AMT Exemption Amounts After 2005			
Filing Status	Maximum Exemption	Exemption Phase-Out	
		Reduced by 25% of AMTI Over:	Total Phase-Out at AMTI Over:
Single or Head of Household	\$33,750	\$112,500	\$247,500
Married Filing Joint or Qualified Widower	\$45,000	\$150,000	\$330,000
Married Filing Separate	\$22,500	\$75,000	\$165,000

revert back to 2002 levels.

Table 1 shows the AMT exemption amounts for the next few years.

AMT's Expanding Reach

Inflation is one of the main reasons that more taxpayers are becoming subject to AMT. The AMT exemption amounts and AMT tax bracket amounts are not annually indexed for inflation.

The first minimum tax system introduced back in 1969 provided an exemption amount of \$30,000. If not for the temporary increases to the AMT exemption discussed above, the AMT exemption would have been only \$45,000 for married taxpayers in 2005. If the original exemption amount had been indexed for inflation, it would be approximately \$150,000 today. Therefore, due to the lack of inflation adjustments in the AMT system, a taxpayer's exposure has greatly increased.

Another key factor that has caused more taxpayers to pay alternative minimum tax in recent years is the reduction in marginal income tax rates as a result of the 2003 Tax Act. As marginal income tax rates have dropped, so have many individual taxpayers' regular income tax liability. However, their tentative minimum tax liability has remained relatively unchanged. Therefore, as in-

dividuals see a reduction in their regular tax liabilities, their exposure to AMT has greatly increased.

How It Works: The Calculation

Technically, the AMT is the amount by which your tentative minimum tax exceeds your regular tax liability. Individuals are required to calculate both their regular tax liability and their tentative minimum tax liability and pay on the higher of the two tax liability calculations.

The tentative minimum tax is calculated using IRS Form 6251 after you have completed your regular tax calculation. The calculation starts with Line 40 of your 2004 IRS Form 1040—your adjusted gross income less itemized deductions or the standard deduction.

The first item to note is that the starting point is not your regular taxable income, but rather your taxable income *before* any deduction for personal exemptions.

The next considerations are any tax preferences or adjustments you may have. Once you have added the tax preferences and either added or subtracted the adjustments, you will end up with your alternative minimum taxable income (AMTI). Your AMTI is then

reduced by your applicable AMT exemption amount.

If the result is zero or less, your tentative minimum tax is \$0.

If the exemption amount doesn't completely offset AMTI, the remainder is taxed at the AMT tax rates:

- The first \$175,000 of ordinary income is subject to tax at 26% and,
- Any amount above \$175,000 is subject to tax at 28%.
- Long-term capital gains and qualified dividends are subject to tax at 15% in the tentative minimum tax calculation.

The net result of the above calculations is your tentative minimum tax. The tentative minimum tax is then compared to your regular tax liability to determine if you are subject to the AMT.

Table 2 illustrates the calculation of the AMT, and how it compares with the calculation of regular income taxes. Two examples are also presented. The first example is relatively straightforward.

The second example illustrates the true complexity of the tentative minimum tax calculation. In this example, a retired couple receives \$200,000 of qualified dividend income during the year. This amount, which is a majority of their income, is taxed at the lower dividend rate (\$9,603 at the 5% rate

Table 2. Regular Tax vs. AMT: How They Are Calculated

HOW THEY ARE CALCULATED

Regular Tax Calculation

Income

Less: Deductions (Standard or Itemized)
Less: Personal Exemptions

Equals: Taxable Income

Multiplied By Tax Rates
(10% to 35% on Ordinary Income,
15% on Long-Term Capital Gains
and Qualified Dividend Income)

Equals: Regular Tax

Less: Foreign Tax Credit

Equals: Regular Tax Liability

AMT Calculation

Income + Excluded Items

Less: Deductions (Some Disallowed, Some Adjusted)
Less: AMT Exemption (Subject to Phase-Out)

Equals: AMTI (Alternative Minimum Taxable Income)

Multiplied by Tax Rates
(26% to 28% on Ordinary Income,
15% on Long-Term Capital Gains
and Qualified Dividend Income)

Equals: TMT (Tentative Minimum Tax)

Less: AMT Foreign Tax Credit

Equals: Tentative Minimum Tax Liability

$$\text{AMT} = \text{Tentative Min Tax Liability} - \text{Regular Tax Liability}$$

$$\text{Total Tax Liability} = \text{Regular Tax Liability} + \text{AMT}$$

EXAMPLES

Example 1:

A Married Couple with 3 Children and:

Wages	\$140,000
Itemized Deductions:	
State and Local Taxes	\$11,250
Real Estate Taxes	\$2,500
Mortgage Interest	\$7,500
Charitable Contributions	\$1,000
Total	\$22,250

Regular Tax Calculation

Income	\$140,000
Less: Itemized Deductions	(\$22,250)
Less: Personal Exemptions	(\$16,000)
Taxable Income	\$101,750
Regular Tax Liability	\$18,768

AMT Calculation

Regular Taxable Income	\$101,750
Plus AMT Exclusions:	
Personal Exemptions	\$16,000
State and Local Taxes	\$11,250
Real Estate Taxes	\$2,500
Less: AMT Exemption	(\$58,000)
Alternative Minimum Taxable Income	\$73,500
Tentative Minimum Tax (AMTI taxed at 26%)	\$19,110

$$\text{AMT} = \$19,110 - \$18,768 = \$342$$

$$\text{Total Tax Liability: } \$18,768 + \$342 = \$19,110$$

and the remaining \$190,397 at the 15% rate), while the remainder of their income is taxed at the 26% AMT rate.

It is important to note that, although the qualified dividend income is taxed at the lower qualified dividend tax rates, the dividend income pushes the couple into a level of alternative minimum taxable income in which the AMT exemption amount is partially phased out. The result is that, although the couple is in the 26% tax bracket for AMT, their marginal AMT rate is actu-

ally 32.5%. In other words, while technically the qualified dividend income is taxed at the lower rate, their marginal AMT rate increases to 32.5% and causes the taxpayers to pay the AMT.

Who Is at Risk?

There are a number of factors that determine whether a particular taxpayer would be subject to alternative minimum tax. Three of the biggest factors are:

- The taxpayer's overall level of income,
- The number of dependents, and
- Whether or not the taxpayer resides in a state that has high state taxes on income, sales and property.

Level of Income

It should seem obvious that a taxpayer's overall level of income would determine whether they could be subject to the AMT. The bigger surprise is that it is not the highest levels of income

EXAMPLES (CONTINUED)

Example 2

A Retired Married Couple and:

Qualified Dividend Income	\$200,000
IRA Distributions	\$50,000
Taxable Social Security	\$21,250
Itemized Deductions:	
State and Local Taxes	\$12,500
Real Estate Taxes	\$4,000
Charitable Contributions	\$5,000
Total	\$21,500

Allowable Itemized Deductions at Couple's Income Level	\$17,741
Itemized Deductions Lost Due to Phase-outs	\$3,759

Regular Tax Calculation

Income	\$271,250
Less: Itemized Deductions	(\$17,741)
Less: Personal Exemptions	(\$3,712)
 Taxable Income	 \$249,797
Regular Tax Liability	\$35,780

AMT Calculation

Regular Taxable Income	\$249,797
Plus AMT Exclusions:	
Personal Exemptions	\$3,712
State and Local Taxes	\$12,500
Real Estate Taxes	\$4,000
Less: Itemized Deductions Lost Due to Phase-Outs	(\$3,759)
Less: AMT Exemption (Partial Phase-Out)	(\$28,937)
 Alternative Minimum Taxable Income	 \$237,313
Tentative Minimum Tax	\$38,741
(\$9,603 taxed at 5%; \$190,397 taxed at 15%; \$37,313 taxed at 26%)	

$$\text{AMT} = \$38,741 - \$35,780 = \$2,961$$

$$\text{Total Tax Liability: } \$35,780 + \$2,961 = \$38,741$$

that are most subject to AMT, but rather those in between.

For taxpayers with low income levels, the AMT exemption helps reduce exposure to AMT.

For taxpayers with an adjusted gross income over \$500,000, their exposure to the AMT is also reduced because a large portion of their income is taxed at regular income tax rates that exceed the AMT tax rates. Down the road, however, these high-income taxpayers ultimately may not have avoided the AMT trap—the Congressional Budget Office estimates that in the year 2010, 30% of taxpayers with an adjusted gross income over \$500,000 will pay AMT.

Taxpayers with adjusted gross incomes between \$100,000 and \$500,000 have the greatest exposure to the AMT. Most of their income will be taxed at regular tax rates that will not exceed 25%, but for purposes of the AMT they will be subject to tax rates of 26% and 28%. In addition, the AMT exemption is phased-out for married taxpayers with alternative minimum taxable income starting at \$150,000 and completely phased-out when alternative minimum taxable income exceeds \$382,000 [alternative minimum taxable income, as discussed above, is determined by adding back certain preference items and deductions to a taxpayer's adjusted gross income]. According to the Congressional Budget Office, over 90% of the taxpayers with adjusted gross income between \$100,000 and \$500,000 will be subject to AMT in 2010.

Number of Dependents & State Taxes

Exemptions for dependents, and deductions for state taxes (income and property) are among the most common exclusion items that must be added back to a taxpayer's regular taxable income in order to determine their alternative minimum taxable income, which ultimately increases your exposure to the AMT.

AMT Adjustments

Many other factors, however, can

also increase your exposure to the AMT.

It is important to understand the impact that certain AMT adjustments have in your AMT calculation:

- Certain adjustment items create permanent differences and are called exclusion items.
- Other adjustments are only temporary differences and are called deferral items.

An understanding of the difference between deferral items and exclusion items is extremely important. If you are subject to the AMT because of deferral items, you will be able to recapture a portion of the AMT that was paid in future years through the use of a credit—the minimum tax credit.

The following is a list of common exclusion items that *must* be added back to your regular taxable income in order to determine your AMTI:

Exclusion Items

- Personal exemptions, currently \$3,100 per dependent;
- Standard deduction, if claimed;
- State, local and foreign income taxes deducted as an itemized deduction;
- State, local and foreign property taxes deducted as an itemized deduction;
- State and local sales taxes deducted as an itemized deduction;
- Home equity mortgage interest not used to improve a residence that is deducted as an itemized deduction;
- Miscellaneous itemized deductions that exceed the 2% AGI limit that are deducted as an itemized deduction;
- Medical expenses that exceed the 7.5% adjusted gross income limit that are deducted as an itemized deduction must exceed 10% of the adjusted gross income limit to be deductible for the AMT calculation; and
- Tax-exempt interest income from private activity bonds.

All of these items are *not deductible* in the calculation of your tentative minimum tax. In addition, if you were sub-

ject to the AMT because of these items, a minimum tax credit would not be generated.

Common Deferral Items

The following is a list of common deferral items that are either added back to or subtracted from your regular taxable income in order to determine your AMTI:

- Income from the exercise of incentive stock options;
- Disposition of assets with basis adjustments for AMT; and
- Depreciation differences on post-1986 assets.

If you are subject to the AMT due to deferral items, a minimum tax credit is generated that can be used future tax years.

The Minimum Tax Credit

Taxpayers who incur the AMT due to deferral items, have the opportunity to claim a credit against their regular income tax liability in future years. However, the credit can only be claimed in years in which your regular tax liability *exceeds* your tentative minimum tax liability. Therefore, if you are continually subject to the AMT, it may be a period of years before you are able to claim any credit.

The ability to recapture a portion of the AMT as a tax credit has the effect of making that portion of the AMT liability a prepayment of tax, as opposed to a permanent tax liability. Any credit that is not utilized in a given tax year is carried forward to future tax years. The credit is carried forward indefinitely until fully utilized and is claimed on IRS Form 8801.

Planning for the AMT

Effective tax planning should always include income projections for at least two years. By analyzing multiple-year projections, you will have the ability to better determine what items of income or deductions could be shifted across tax years. Not only is the timing of deductions beneficial, but the timing

of the receipt of income is also important when analyzing AMT exposure.

The first step of tax planning is to determine whether you will be subject to tax under the regular tax system or the AMT tax system. Tax planning strategies for individuals *not* subject to the AMT differ from strategies for individuals who *are* subject to the AMT.

If it is determined that you *are* subject to the AMT, the next step is to determine why and how often. You may have a number of either exclusion items or deferral items, or any combination of both. Here are some planning tips to help you reduce your possible AMT exposure due to various scenarios:

- If you are consistently subject to the AMT, you may be limited in your planning options. This is especially true when the AMT is triggered because of exclusion items such as state and local taxes and property taxes. If you are in this situation, it may be beneficial to delay paying state and local taxes and other items that are not deductible for the AMT.
- If you are subject to the AMT and your maximum tax rate is 28%, you may want to consider accelerating income into that tax year. This is especially true if it appears that you will be subject to the regular tax in the 35% tax bracket in the following year. In that instance, you should consider accelerating ordinary income and only accelerating the deductions that would be de-

ductible for the AMT.

- If you will be subject to AMT one year and regular tax the next, significant benefits can be recognized by effective tax planning. In this instance, you should defer state and local taxes, miscellaneous itemized deductions and other AMT adjustments to the year in which you will *not* be paying the AMT. In addition, you should claim as many of your other deductions as possible in the year in which you are subject to regular tax. For example, if you are subject to the AMT in one year, you may be limited to a 28% tax benefit on a charitable contribution. However, if you are subject to regular tax in the 35% tax bracket, you would receive a 35% tax benefit on the same charitable contribution.
- If you plan on selling a large stock position with low basis or have substantial qualified dividend income, you should check your exposure to the AMT. Although these items would only be subject to a maximum 15% federal tax, it might cause all other items of income to be taxed at a much higher tax rate. You will notice in the second example that the couple's ordinary income is actually taxed at 32.5% and not 26% or 28%. *For individuals with alternative minimum taxable income between \$175,000 and \$382,000, your marginal tax rate for the AMT may be as high as 35%.* This is a result of the AMT exemption phase-out. For

individuals in the phase-out range, your marginal tax rate is actually 125% of the bracket amount. For example, if you are subject to an AMT rate of 28%, your marginal AMT tax rate is actually 35% ($28\% \times 1.25$). Therefore, if you are thinking about triggering additional ordinary income, you may end up paying 35% federal tax and not 28%. In addition, you may trigger a large state tax liability on capital gains and qualified dividends, which would further increase your exposure to the AMT. Make sure you plan ahead for these kinds of situations.

There are many factors that may cause you to be subjected to the AMT. The primary goal in AMT tax planning is to minimize your total federal tax liability over a period of years. The time value of money will factor into the tax-planning decisions made based upon the multi-year analysis.

Conclusion

Consider yourself lucky if you have not yet been subject to the alternative minimum tax. However, the odds are against you that you will be able to completely avoid it in the coming years.

For that reason, you may want to consider consulting with a professional tax advisor or financial planning advisor who understands the AMT and can assist in planning and developing strategies to help minimize overall tax liabilities. ▲

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