The Alternative Minimum Tax

Introduction

The Alternative Minimum Tax (AMT), like the passive activity rules, was enacted in 1986 to curb perceived abuses by high-income taxpayers to minimize their current income tax liability. The AMT is the ultimate tax oxymoron. It is neither alternative (it must be used to calculate tax liability), nor is it minimum (the imposition of the AMT means that the taxpayer will have to pay more tax than that calculated using the regular tax system). Understanding why, and how, the AMT is imposed is important for planners who are advising clients who may be caught by its snares.

As an anti-abuse technique, the AMT is designed primarily to change the timing of tax payments although, in some cases, imposition of the AMT results in a permanent increase in tax. Long ago taxpayers learned that it is generally a good thing to pay less tax now, and defer tax liability into the future. Several planning techniques were developed to do just that, resulting in a loss of current revenue for Congress. Congress would rather have taxpayers pay more now, and less later, since this approach fills federal coffers and minimizes the need to borrow to fund governmental expenditures. Furthermore, Congress felt it was unfair to allow wealthy taxpayers to participate in activities that reduce or eliminate their current tax liability in ways that were not available to rank-and-file taxpayers. The AMT is designed to offset the timing impact of tax deductions, so that those who are impacted by it will have the opportunity to pay more tax now, and less in the future. Generally, those who are impacted by the AMT are taxpayers who take advantage of “items of tax preference.”

How the AMT Works

The AMT is an alternative tax calculation. When a taxpayer prepares his or her income tax return, two tax calculations should be completed. The first calculation will use the regular tax system, and is calculated on the taxpayer’s Form 1040. The second calculation is the alternative minimum tax, and is calculated on Form 6251. A taxpayer is liable for the greater of the regular tax liability, or the tentative minimum tax calculated for AMT on Form 6251.

To calculate the AMT, the taxpayer will start with his or her taxable income from the Form 1040, and will make changes to that number. The changes made to Regular Taxable income are referred to as adjustments or preferences. Adjustments can either
increase or reduce Alternative Minimum Taxable Income (AMTI), while preferences always result in an addition to AMTI. Once all adjustments and preferences have been accounted for, AMTI is calculated. An exemption is subtracted from AMTI to arrive at the AMT tax base, to which the AMT rate is applied. For individuals, the AMT tax rate is 26% on the first $175,000 of income ($87,500 for those married filing separately), and 28% on the excess. The result at this point is referred to as the tentative minimum tax, which is further reduced by any Foreign Tax Credit that the taxpayer may claim, and the taxpayer’s regular tax liability from Form 1040. The AMT formula can be illustrated as follows:

\[
\begin{align*}
\text{Taxable income} & \quad + \quad \text{Adjustments} \\
+ & \quad \text{Preferences} \\
\text{AMTI} & \quad - \quad \text{Exemption} \\
\text{AMT tax base} & \quad x \quad \text{AMT rate(s)} \\
\text{Tentative minimum tax} & \quad - \quad \text{Foreign tax credit} \\
& \quad - \quad \text{Regular tax} \\
\text{Equals AMT}
\end{align*}
\]

The exemption used for the AMT calculation depends on filing status. The following table shows the exemption amount for 2008.

<table>
<thead>
<tr>
<th>Filing Status</th>
<th>AMT Exemption</th>
</tr>
</thead>
<tbody>
<tr>
<td>Single &amp; Head of Household</td>
<td>$33,750</td>
</tr>
<tr>
<td>Married Filing Jointly &amp; Qualifying Widow</td>
<td>$45,000</td>
</tr>
<tr>
<td>Married Filing Separately and Estates and Trusts</td>
<td>$22,500</td>
</tr>
</tbody>
</table>

Unfortunately, the story with exemptions does not end here. To the extent that AMTI exceeds certain amounts, the exemptions begin to phase out. The phaseout rule states that the exemption amount is reduced by 25% of the amount by which AMTI exceeds:

<table>
<thead>
<tr>
<th>Filing Status</th>
<th>AMT Exemption Phaseout Threshold</th>
</tr>
</thead>
<tbody>
<tr>
<td>Single &amp; Head of</td>
<td></td>
</tr>
</tbody>
</table>

High income taxpayers, therefore, may have their AMT exemption limited, or may not be able to use any exemption in the calculation of their alternative minimum tax.

In some cases, triggering the AMT causes a permanent increase in tax. In other cases, the AMT merely changes the timing of the tax payment. Adjustments and preferences are classified as either exclusion items, or deferral items. Exclusion items result in a permanent increase in tax. Deferral items result in a tax credit equal to the additional tax that must be paid in the current year, and this credit can be used to offset tax liability in a future years when the taxpayer is no longer subject to the AMT. There is an unlimited carry-forward for the AMT credit generated from deferral items, but the credit may not be carried back and applied against regular tax liability in past years. From a planning standpoint, therefore, deferral items are the better AMT preferences and adjustments to have.

One additional issue that is important to planners is the impact of capital gains on the AMT. Capital gains are taxed at the same rate for AMT purposes as they are for regular tax purposes. As a result, even though capital gains have a lower tax rate than the regular AMT rates, capital gains will not force a taxpayer to become an AMT taxpayer.

Adjustments and Preferences

As illustrated in the AMT formula, the key planning issues surrounding the AMT involve the adjustments and preferences that are added to regular taxable income to arrive at alternative minimum taxable income (AMTI). For simplicity, we will review these adjustments and preferences in three categories: (1) Itemized Deduction Changes; (2) Investment related changes; and (3) Business related changes.

Itemized Deduction Changes

From a personal financial planning standpoint, itemized deduction changes are perhaps the most important of the three categories. Many financial planning clients itemize deductions, and it is important for the planner to know what adjustments may be made if the client becomes an AMT taxpayer.
The first adjustment that must be made for itemized deductions involves Home Mortgage interest. Generally, qualified mortgage interest paid to acquire a primary and secondary residence is deductible for regular and AMT tax purposes. If, however, the mortgage is refinanced in an amount in excess of the original mortgage, interest on the excess refinancing (Current Mortgage – amortized original mortgage), must be added back to income to calculate AMTI.

Second, if medical and dental expenses were claimed as a deduction for regular tax purposes, an additional 2.5% of the taxpayers adjusted gross income must be added back to income for purposes of calculating AMTI. The impact of this rule is that medical and dental expenses are deductible for AMT purposes only if they exceed 10% (7.5% + 2.5%) of the taxpayer’s adjusted gross income for regular tax purposes.

Third, any state or local income, property, or sales taxes claimed as a deduction for regular tax purposes must be added back to income to determine AMTI. No deduction is allowed for state and local taxes once the taxpayer becomes an AMT taxpayer.

Finally, miscellaneous itemized deductions are added back to income to determine AMTI. There are exceptions to this rule, for example, certain deductions for estate tax (the estate tax attributable to the inclusion of Income in Respect of a Decedent (IRD) assets in the decedent’s estate), wagering, casualty loss and investment interest to the extent of net investment income are allowed as a deduction for AMT purposes. All other miscellaneous itemized deductions must be added back, however.

In summary, to calculate AMTI the following itemized deductions must be added back to income:

- Home mortgage interest on excess refinancing (Current mortgage – amortized original mortgage)
- An additional 2.5% of medical and dental expenses
- State and local income, property, and sales taxes
- Most miscellaneous itemized deductions.

Note that charitable contributions and casualty losses are not impacted in any way by the AMT rules, and do not have to be added back into income (or, an alternative way of thinking of this is reversed out) when calculating AMTI.

Itemized deductions are subject to phaseout for high income taxpayers. This phaseout rule does not apply when calculating AMTI. Therefore, taxpayers in the phaseout range must reduce their taxable income by the amount of the phaseout attributable to allowable itemized deductions for AMT purposes when calculating AMTI.
Beginning in 2006, the itemized deduction phaseout is itself being phased out over a series of years. Until the phaseout has been eliminated, any reduction in itemized deductions caused by the phaseout rule should be added to taxable income in calculating AMTI.

If an individual does not itemize deductions, the standard deduction is added back to taxable income when calculating AMTI. Only the allowable itemized deductions noted above may be used as deductions for AMT purposes.

Once the changes for itemized deductions necessary to calculate AMTI have been made, the next question that becomes important is “Are these exclusion or deferral items?” Unfortunately, all of the itemized deduction changes are classified as exclusion items. Any additional AMT generated by adding these items to calculate AMTI will not result in the creation of a credit that can be used against regular tax liability in the future, but will rather result in a permanent increase in tax for the taxpayer.

**Investment Related Changes**

Certain investment activities may also have an impact on AMT. The two most important considerations from a planning standpoint are (1) interest on private activity municipal bonds, and (2) exercise of Incentive Stock Options (ISOs).

**Private Activity Municipal Bonds**

Interest earned on private activity municipal bonds is excluded from tax for regular income tax purposes, but must be added back to taxable income to arrive at AMTI for AMT purposes. Adding back the interest potentially subjects the interest to tax. Recall that if a client would like to purchase a municipal bond that will be fully exempt from income tax (both regular and AMT), he or she could purchase a public purpose municipal bond.

You may recall that, as a general rule, taxpayers can only deduct expenses for income tax purposes if the amount claimed had already been brought into income. Applying this general rule to municipal bonds, we learned that investment interest expense associated with acquiring a portfolio of municipal bonds was not deductible for regular tax purposes since the income generated by the bonds was exempt from tax. (Alternatively stated, since the taxpayer purchasing municipal bonds was not sharing his or her gains with Uncle Sam, Uncle Sam does not allow a tax deduction for the interest incurred to acquire the investment.) When municipal bond interest becomes taxable under the AMT system, however, any investment interest paid to acquire the bonds will be deductible when arriving at AMTI. This adjustment for investment interest expense
used to acquire the municipal bond portfolio is in concert with the general rule that allows deductions for expenses incurred in purchasing investments where the gains from the investment will be shared with the government in the form of tax revenue.

The add-back of the interest on private activity municipal bonds, and the deduction permitted for investment interest incurred to acquire those bonds, are considered to be AMT exclusion items. As a result, any increase in tax caused by the adjustments for private activity bonds will be a permanent increase in tax for the taxpayer, and no credit will be available to offset future regular tax liability.

**Incentive Stock Options (ISOs)**

Another investment related activity that could have an impact on a taxpayer’s AMT liability is the exercise of Incentive Stock Options (ISOs).

There are two types of stock options – Incentive Stock Options and Non-qualified stock options.

A non-qualified stock option (NQSO) is a right to purchase shares of company stock at a given strike price (generally set at the market price of the stock on the day the option is granted). The exercise of a non-qualified stock option results in ordinary income for the taxpayer equal to the difference between the value of the stock on the day of exercise and the strike price of the option. When a non-qualified stock option is granted to an employee, the employer must withhold taxes on exercise, including employment (social security taxes). Since a non-qualified option results in ordinary income tax treatment, it is not a preference item for AMT purposes and does not have to be added back to taxable income to arrive at AMTI (it is already included in taxable income).

An Incentive Stock Option (ISO) has different characteristics. To qualify as an ISO, the issuing company must comply with a host of special rules. The advantage of an ISO, as compared to a non-qualified stock option, is that if the taxpayer meets the holding period requirement, the gain on the option will be taxed as capital gain instead of ordinary income. To qualify for capital gain tax treatment, the stock must be held 2 years from the date of grant, and one year from the date of exercise. If either part of this two-pronged holding period test is not met, the taxpayer will have to report the gain as ordinary income. At the execution of an ISO, therefore, there is no immediate regular income tax consequence since it is not possible to determine, at that time, whether the gain will be taxed as ordinary income or as a capital gain. If the taxpayer exercises the option and sells the stock within one year (referred to as a disqualifying disposition), the
gain will be taxed at ordinary rates because the holding period was not met, and the ISO will be treated similarly to an NQSO.

While the exercise of an incentive stock does option not impact the taxpayer’s regular tax liability, it may result in the imposition of the AMT. The difference between the value of the stock on the date of exercise and the strike price of the option must be added to taxable income to arrive at AMTI. When a taxpayer exercises a large number of options in one tax year, and does not sell the stock (thereby triggering a disqualifying disposition and imposing ordinary income tax on the gain), there is a danger of becoming an AMT taxpayer.

EXAMPLE: Ryan, a single individual who is an executive at Murphy’s Consulting, Inc. was granted 1,000 ISOs on Murphy’s stock two years ago when the price per share was $15.00. The last few years have resulted in tremendous growth for Murphy’s and the stock is now valued at $75 per share. Ryan exercised the ISOs, but did not sell the stock – he plans on holding the shares for at least a year so he can pay the lower capital gains tax rate on the growth. Even though exercise of the options results in no taxable event for regular tax purposes this year, Ryan will have to add $60,000 to his taxable income when computing AMTI. If there are no other transactions this year that could reduce AMTI, it is likely that Ryan will become an AMT taxpayer for the year, since the tax preference item – the gain on the exercise of the ISO – is greater than his exemption for AMT purposes.

EXAMPLE: Assume the same facts as above, except that Ryan exercises the options and sells the shares. In this case, since there was a disqualifying disposition of the stock (Ryan did not meet the two year from date of grant/one year from date of exercise holding period), the gain will be taxed as ordinary income to Ryan this year. Since the gain is included in income, there is no adjustment to be made when calculating AMTI, since the gain is included in his taxable income (the starting point for AMTI). In a circumstance such as this, it is unlikely that Ryan will become an AMT taxpayer in the current year.

From a planning standpoint, it may be wise to counsel clients with ISOs to exercise the ISOs in small amounts over time so that the gain is not bunched into one tax year. This approach will minimize exposure to the AMT, but can be somewhat costly – the taxpayer will have to have the funds necessary to exercise the options.

Unlike the itemized deduction changes and the changes required for private activity bonds, the additions to taxable income from ISOs are considered deferral items.
(not exclusion items), and any AMT generated by including the ISOs in AMTI will become a credit that can be used to offset future, regular tax liability.

**Other Investment Related Changes**

In addition to the AMT rules concerning private activity municipal bond interest and incentive stock options, adjustments must be made for certain transactions when the taxpayer moves to AMT status. In particular, gains or losses on the sale or disposition of property must be recalculated if the taxpayer’s AMT basis in the asset is different than his or her regular basis. Likewise, loss limitations imposed by the amount at risk limitation and the passive activity rules must be recalculated taking into account any adjustments required for AMT purposes. While calculation of these adjustments is beyond the scope of this text, you should be aware that these adjustments are often necessary due primarily to changes in allowable depreciation deductions, which will be discussed briefly below. When calculating AMTI, certain adjustments must be made to the depreciation deductions taken for regular tax purposes, and these adjustments must also be taken into account when considering gain/loss and passive limitations when calculating the alternative minimum tax.

**Business Related Changes**

One of the advantages of using an asset in the active conduct of a trade or business is the ability to claim depreciation deductions, which allows the taxpayer to recoup his or her capital before the asset is disposed of. Asset class lives and depreciation scales are provided for both real and personal property. When a taxpayer becomes an AMT taxpayer, however, the depreciation scales lengthen, requiring the taxpayer to add back some of the depreciation claimed for regular income tax purposes.

In addition to regular depreciation, the Code allows quicker write-offs, and, in some cases, immediate write-offs for certain specified expenditures. Usually, Congress allows businesses to immediately expense costs in an effort to provide an incentive for investment in that area. Expenditures that qualify for these special rules include circulation costs (for publishers), intangible drilling costs (for oil and gas investors), mining costs (for natural resource extractors) and research and experimental costs (for scientific enterprises). If a taxpayer moves from regular status to AMT status, adjustments must be made to the expenses claimed on these activities so that, usually, the taxpayer will have to add part of the expense claimed back to taxable income in arriving at AMTI.

All of the depreciation and accelerated expense adjustments mentioned above are considered to be deferral items for AMT purposes. If any AMT is generated due to the inclusion of these items in AMTI, the taxpayer will receive a credit of a like amount that can be used against future regular tax liability. These adjustments change the timing of
the payment of tax (they require the taxpayer to pay more now, less later), but do not result in a permanent increase in tax burden.

Two additional business related changes are exclusion items, resulting in a permanent change in tax burden if their inclusion causes the taxpayer to be subject to the AMT. The business related exclusion items are (1) depletion, and (2) qualified small business stock (under Sec. 1202).

Depletion is a form of depreciation that applies to natural resources. As minerals are extracted from the earth, the owner of the mineral rights may claim a depletion deduction to recoup some of his capital in acquiring the mineral rights. When a taxpayer moves into AMT status, the deduction for depletion must be recalculated taking into consideration allowable AMT income and deductions from the activity. Once the taxpayer is subject to the AMT, the depletion deduction is further limited to the taxpayer’s alternative minimum tax basis in the activity. Compared to the allowable depletion rules in the regular tax system, this rule severely limits the taxpayer’s ability to claim deductions. As noted above, the depletion changes are exclusion items. Once the adjustment is made and the AMT is triggered, the taxpayer’s tax burden has been permanently increased.

In an effort to encourage individuals to capitalize small corporations, Sec. 1202 of the Code allows investors of qualified small business stock to exclude 50% of the capital gain from income. If a taxpayer claiming a Sec.1202 exclusion becomes an AMT taxpayer, however, the excluded gain must be multiplied by 7%, and that amount must be added back to taxable income in arriving at AMTI. If the gain on Sec. 1202 stock is large, the gain alone could cause a taxpayer to move into AMT status. Too much of a good thing can trigger the AMT – but, that is what the AMT was designed to do – minimize the ability of high income taxpayers to artificially manipulate their income tax liability down by taking advantage of tax preference items. Remember that the adjustment for Sec. 1202 stock is an exclusion item, resulting in a permanent increase in tax liability for the taxpayer.

**Miscellaneous Adjustments**

In addition to the major categories of changes described above, when a person becomes an AMT taxpayer, several other adjustments must be made to the tax return as well (to calculate AMTI). While these adjustments are beyond the scope of this text, you should be aware that adjustments will be made to Sec. 179 depreciation deductions, expenses associated with business use of the taxpayer’s home, deductions for IRAs, Keogh, SEP, and SIMPLE plans, the self employed health insurance deduction, and distributions from IRAs.
Corporations and the AMT

Corporations are also subject to the AMT. The AMT tax rate that applies at the corporate level is 20%. Many of the adjustment and preference items discussed above with respect to individual taxpayers also apply to corporations, and there are additional corporate AMT rules that need to be complied with. A discussion of corporate AMT rules is beyond the scope of this text.

One corporate AMT rule is directly relevant to financial planners, however. Many financial planners deal with clients who have family or closely held businesses, and these businesses are often structured in corporate form. Since 1997, small corporations have been exempted from the AMT. A small corporation is defined as a corporation with average gross receipts of $5 million or less for the past three taxable years. Once a small corporation achieves exemption from the AMT by meeting this rule, it remains exempt as long as three year average gross receipts do not exceed $7.5 million. Once three-year average gross receipts exceed $7.5 million, the corporation is subject to the corporate AMT.

Conclusion

The AMT, like the passive activity rules, is designed to prevent abusive practices resulting in low current tax liability for wealthy individuals. While its application is complex, the idea is simple. Understanding the types of activities and events that may cause the imposition of the AMT gives financial planners an edge in counseling clients who may find themselves subject to this alternative tax system.