

# AMT: What Is It and Why Should I Care?

By Michael Hayes, EA

If it hits you, you'll probably think it means "awful maddening tax" because you'll be mad when you pay it!

It's actually Alternative Minimum Tax or AMT. In this article, I will discuss some aspects of AMT as it applies to individual taxpayers. Internal Revenue Code (IRC) Sections 55 (Alternative Minimum Tax Imposed), 56 (Adjustments in Computing Alternative Minimum Taxable Income), 57 (Items of Tax Preference), 58 (Denial of Certain Losses), and 59 (Other Definitions and Special Rules), and the associated regulations pertain to AMT for individuals.

# The Alternative Minimum Tax, A Parallel Tax System

The alternative minimum tax was included in the Tax Reform Act of 1986 to ensure that wealthy individuals and successful corporations paid their fair share of taxes. Congressional tax writers were concerned that these taxpayers were zeroing out on their tax liability. In other words, because of the way they structured their finances, they owed no tax and perhaps received a sizable refund instead. Meanwhile, middle income and working class wage earners were actually paying higher taxes than say, General Electric. The tax committees in the House of Representatives and the Senate believed this was undermining the perceived fairness of the tax system and they had some evidence that middle income taxpayers, feeling like

chumps for paying taxes while others did not, were finding creative ways to shave their tax liability.

The AMT was structured to capture a broad measure of income and does not permit the exclusion or deduction of many items (tax preferences) normally deductible or excludible under the regular tax system. Unfortunately, the AMT has not been adjusted for inflation and with only minor tinkering by Congress over the ensuing years, it is affecting many more taxpayers, including those in the middle class.

The AMT has registered as NAEA's "Tax Headache of the Year" for several years running as it has affected members' clients who have exercised incentive stock options, who have large capital gains, large numbers of exemptions or who happen to live in high tax states. Nina Olson, the National Taxpayer Advocate, in her annual Report to Congress has identified the AMT as an area in need of Congressional attention. The U.S. Department of the Treasury estimates that the AMT will affect 13.4 million taxpayers in 2005 and as many as 35 million taxpayers in 2010.

If the prediction for 2010 comes true that more than 35 million taxpayers will be hit by AMT, about one in every four taxpayers will be affected by AMT.

Should you worry? No.

Should you do some planning? Yes.

Will Congress change the law between now and 2010? Yes, probably every year.

Will Congress change AMT so it affects fewer taxpayers? Maybe.

Before I talk about this in detail, I'll describe a real life situation I encountered. A client got divorced, was working in a low wage job, and had never handled the family finances. The client received a large block of stock as part of the divorce settlement. The stock paid a good dividend which the client liked receiving since it exceeded 25% of wages. The stock had been obtained years ago and had done very well. The tax basis (amount paid for the stock) was very low. A stock broker convinced the taxpayer that it was necessary to diversify. [As an aside, I agree in principle with that idea (diversification), and I also agree that taxes should not be the overriding factor in investment decisions. However, taxes shouldn't be ignored either.]

The taxpayer had a \$600,000 profit, about 30 times the taxpayer's wages! The

federal taxes on this were about \$125,000 which included about \$5000 of AMT. New York taxes were about \$41,000. This is an effective tax rate of just under 28%. There appeared to be a \$15,000 charge for the investments made by the broker. Including fees, this taxpayer's investments would have to go up by about 43% more than the previous investment just to break even! This happened before Enron and others like it "blew up," so the argument for diversifying all at once was weaker then than it would be now. The concept was good. In my opinion, the execution in this case borders on unethical (at best).

Notice that this taxpayer had two of the attributes (large capital gains and high state taxes) mentioned previously in the WSJ column above. If you live in a high tax state such as California, Massachusetts, and New York, you've already got one strike against you!

From what I've read, taxpayers with income between about \$200,000 and

\$500,000 are more likely to get hit with AMT than those with lower or higher income. The lower income part of the equation is probably obvious. The reason people with higher income are less likely to pay AMT is because the regular tax marginal tax rate (maximum 38.6% for 2002) exceeds the AMT tax rate at high income levels. Probably very few of you or your clients have an income exceeding \$200,000. So, why should you care? Three reasons: inflation, tax rate reductions, and credit limitations.

The regular tax brackets, standard deduction, and exemption amounts are indexed to inflation. That means they rise at roughly the inflation rate each year. For example, if inflation over the next 10 years is 30%, the point where a single taxpayer goes into the 25% tax bracket (currently 27% - scheduled to be reduced to 25% in future years) would be about \$36,300 (up from \$27,950). It would be about \$72,600 (up from \$46,700) for a married couple

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## About the Author:

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since the beginning of the 25% marginal tax bracket eventually becomes double the single bracket to help reduce the marriage penalty. This means that more of your income will be taxed at a lower rate. AMT tax brackets are *not* indexed for inflation, nor is the AMT exemption amount.

There's a small increase in the AMT exemption amount that lasts until December 31, 2004. After this date, it reverts to what it was in the year 2000. The \$49,000 exemption amount for 2002 is increased to \$58,000 for 2003 and 2004 (reverts to \$45,000 in 2005 under current law) and is subject to a phase-out of 25% of AMT taxable income in excess of \$150,000. The 2002 AMT exemption for single and head of household filers is \$35,750 and is increased to \$40,250 for 2003 and 2004 (reverts to \$33,750 in 2005), subject to a phase-out of 25% for taxable income in excess of \$112,500. The AMT exemption amount for married individuals filing separately is \$24,500 (reverts to \$22,500 in 2005), subject to a phase-out of 25% of taxable income in excess of \$75,000.

I'm sure this is confusing, so here's an example to further clarify the point:

Jack and Jill, a married couple, have an adjusted gross income of \$75,000 in 2003. They have 10 dependent children and take the standard deduction. Their 2003 regular tax before credits will be about \$3639. They would actually owe AMT of about \$781 for a total tax of \$4420 (\$3639 regular tax + \$781 AMT). Nice, isn't it? Their tax after the child tax credit would be zero. However, since this credit is refundable (and is allowed to be applied against AMT) for this couple, they are still, in effect, paying AMT since their refund is \$781 smaller than it would be otherwise.

Now let's fast-forward 10 years to 2012. Assume the new tax law doesn't die on December 31, 2010, that AMT isn't

changed, and that they have 6 dependent children at that point. Also assume their income exactly tracked inflation, so it's \$97,500 in 2012. Their regular tax would be about \$7715. Their AMT would be about \$5935 for a total tax of \$13,650.

Tax rate reduction in future years will also increase the number of people subject to AMT. Tax brackets are 10%, 15, 27, 30, 35, and 38.6 for 2002. Under current law, tax rates have been reduced to 10%, 15, 25, 28, 33, and 35 for 2003. AMT tax brackets are 26% for alternative minimum taxable income (AMTI) less AMT exemption amount = \$175,000 or less, and 28% above that. Note that the middle tax bracket (25%) is less than even the lower AMT tax bracket of 26%. In effect, Uncle Sam is giving with one hand (lower marginal tax rates) and taking away with the other (AMT). See above for a discussion of the phase out points and percentages for AMT exemption.

Finally, only the child tax and adoption credits are permanently allowed against AMT. Other popular credits, such as the child care and education credits, are not permanently allowed against AMT. These credits are allowed against AMT in 2002 and 2003 (and, I believe, 2004), but not in years after that (unless the law is changed). So, what does this mean? In the example above, it means this couple couldn't claim the child care or education credits in 2005 or later years. Given the popularity of these credits, my guess is that the law will be changed to allow these credits against AMT after 2004.

Here's another example. Let's say Joe and Mary's regular tax, as shown on their tax return for 2005, is \$10,000 and their tentative minimum tax is \$9500. So, they're not paying any AMT. Good, right?! Let's also assume they qualify for a \$960 child care credit. However, the difference between the regular tax and AMT is only

\$500 (\$10,000 - \$9500). Guess how much of their child care credit they can actually claim. You guessed it - \$500. This is insensible.

## Alternative Minimum Tax Income

The Job Creation and Worker Assistance Act of 2002 temporarily extends the general net operating loss (NOL) carryback period to five years (from two years, or three years in certain cases) for NOLs arising in taxable years ending in 2001 and 2002. The Act also allows an NOL arising in or carried forward to taxable years ending in 2001 and 2002, to offset 100% (instead of 90% as in prior tax law) of a taxpayer's alternative minimum taxable income (AMTI). As far as I know, the recently passed tax law (Jobs and Growth Tax Relief Reconciliation Act of 2003) did not change the NOL rules. So, in 2003 and later, NOLs will only be allowed to offset 90% of a taxpayer's AMTI.

To calculate AMT, you first need to calculate AMTI. The starting point for calculating AMTI is regular adjusted gross income (AGI). Note that the standard deduction and personal and dependent exemptions are *not* allowable deductions for calculating AMTI. This is why taxpayers with a lot of exemptions sometimes have to pay AMT. Some itemized deductions are allowed to reduce AMTI, and some aren't. Here's the list:

**Medical:** For AMT purposes, medical deductions are only allowed to the extent they exceed 10% of regular tax AGI (instead of 7.5% for regular tax purposes). That means you might have to add as much as 2.5% to regular tax AGI for this item. If you have a medical deduction for regular tax purposes, you'll always have an add-back for AMT purposes. What's that mean in English? Here are two examples.

Example 1: Say your regular tax AGI is \$100,000 and that your unreimbursed after-tax medical and dental expenses total \$9000. For regular tax purposes, you can deduct \$1500 as an itemized deduction (7.5% of AGI = \$7500 and \$9000 - \$7500 = \$1500). For AMT purposes, none of your medical expenses would be deductible since they are less than 10% of your AGI. You have to add the \$1500 back to your income for AMT purposes.

Example 2: Say your regular tax AGI is \$100,000 and that your unreimbursed after-tax medical and dental expenses total \$11,000. For regular tax purposes, you can deduct \$3500 as an itemized deduction (7.5% of AGI = \$7500 and \$11,000 - \$7500 = \$3500). For AMT purposes, you can only deduct \$1000 of your medical expenses (10% of AGI = \$10,000 and \$11,000 - \$10,000 = \$1000). You have to add \$2500 (\$3500 allowable for regular tax purposes - \$1000 allowable for AMT purposes) back to your income for AMT purposes.

**Taxes:** Believe it or not, the itemized deduction for taxes is not allowed at all for AMT purposes. You have to add back your entire state & local income tax, real and personal property tax, and other tax deductions to your regular tax AGI for AMT purposes. That's why residents of high tax

for AMT purposes ( $\$2000 = 5/6 * \$2400$ . Note  $\$25,000/\$30,000 = 5/6$ ).

**Miscellaneous Deductions:** The miscellaneous deductions that are subject to the 2% of AGI floor are not allowable at all for AMT. These are primarily unreimbursed job and investment expenses plus tax preparation fees. Add whatever you deducted back to regular tax AGI when calculating AMTI.

There's an interesting discussion in the Taxpayer Advocate reports of how legal fees paid for discrimination (race, age, etc.) and similar lawsuits are handled. In most parts of the country, any awards that aren't due to physical injury must be reported in their entirety as other income on Form 1040. Legal fees are deducted on Schedule A as miscellaneous deductions subject to the 2% of AGI floor. If the

decided this issue one way or the other. Of course, the IRS position is that netting is not allowed. So, the aggressive position is to do netting, knowing that the IRS might challenge that. This might or might not withstand an IRS challenge in court in New York. I had a client that was affected by this many years ago. The difference between netting and including the whole amount in income and taking the miscellaneous deduction (subject to 2%) on Schedule A was about \$8000. This difference was primarily due to AMT. After much research and vacillating back and forth, I chose netting and attached a statement to the return stating what I did. The IRS let it go. As it turned out, this taxpayer owed \$7000 with netting and would have owed \$15,000 without netting. She didn't even have the \$7000, much less the

## Here are several references that give further background on AMT.

According to the *New York Times*, it would cost the U.S. Treasury over \$600 billion over 10 years if AMT were totally eliminated. That's a big chunk of change to make up, even in Washington. So, it's hard to predict what Congress might do. See <http://www.nytimes.com/2002/02/17/business/yourtaxes/17AMTT.html>.

The IRS Taxpayer Advocate also discussed AMT in fiscal years (FY) 2000, 2001, and 2002 reports. See <http://www.irs.ustreas.gov/advocate/article/0,,id=97404,00.html> for these reports.

The Joint Committee on Taxation prepared a study in 1999 that analyzed the impact of AMT. See <http://www.house.gov/jct/x-39-99.htm>.

states such as New York or California can get hurt. You pay the taxes, but don't get any deduction for AMT purposes.

**Mortgage Interest:** Mortgage interest to buy and build a first or second home is allowable for AMT purposes. Interest on home equity loans, home equity lines of credit, second mortgages, etc., to the extent they're not used for home improvements are *not* allowed for AMT purposes. For example, say you receive a \$30,000 home equity loan and use \$5000 to replace the roof on your residence and \$25,000 to buy a new car. You're supposed to add back the interest on \$25,000 to your regular income tax AGI for AMT purposes.

For example, say you paid \$2400 of interest on the \$30,000 loan. You're supposed to add \$2000 to your regular AGI

award is substantial, it is highly likely that AMT will be triggered. {See the FY 2002 Taxpayer Advocate report for the states in which "netting" (subtract legal fees from the award and report only the net amount as other income) will generally not be contested by the IRS.}

The Taxpayer Advocate includes an example of a case with an effective tax rate exceeding 100%! The taxpayer won \$300,000 plus \$950,000 in legal fees. AMT caused the \$950,000 deduction to disappear, and the tax on \$1.25 million ( $\$300,000 + \$950,000$ ) exceeded \$300,000.

There are differing interpretations in the appellate courts as to whether netting is allowed. State laws have affected the courts' decisions. It turns out that the appellate court covering New York has not

\$15,000. She never returned as a client, so I don't know if the IRS ever did challenge this tax return.

**Disallowed Itemized Deductions:** If your regular tax AGI exceeds \$137,300 (\$68,650 if married filing separately) for 2002 (I didn't look up the 2003 phase out amounts), you lose a portion of your itemized deductions (3% of the excess of AGI over the threshold). That's not true for AMT, i.e., the allowable AMT itemized deductions aren't reduced if your AGI exceeds this threshold. So, you actually get to subtract whatever you lost for regular tax purposes when calculating AMTI. For example, say your regular tax AGI is \$147,300. This exceeds the threshold by \$10,000 ( $\$147,300 - \$137,300$ ). So, you lose \$300 of your itemized deductions



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(\$10,000 x 3% = \$300) for regular tax purposes. Subtract the \$300 from regular tax AGI when calculating AMTI.

**Tax Refund:** Because taxes aren't allowed as a deduction for AMT purposes, any state tax refund included in your income for regular tax purposes is subtracted out for AMT. For example, say you got a \$350 state tax refund in 2003 and have to include it in income (Form 1040, line 10) because you itemized the year before. You get to subtract the \$350 from regular tax AGI when calculating AMTI.

**Incentive Stock Options (ISO):** In my opinion, this is probably one of the most unfair items in AMT law. The bargain element of an ISO, which is the difference between the option price and the fair market value of the stock on the date of exercise, is added to regular income for AMT purposes.

My understanding is that this has severely impacted a lot of people in the "dot.com" business. These taxpayers exercised their options (i.e., purchased the stock at the option price when the option price was significantly less than the stock price on the exercise date) when everyone thought that these stocks would keep increasing in value. Of course, many of these stocks crashed. Taxpayers who didn't sell the stock purchased with ISO options the same year often paid AMT. If the stock later crashed, such taxpayers often realized less in the subsequent stock sale than they owed in taxes.

Example: In 1999, Joe Computer exercised an ISO for \$2 per share when the fair market value (FMV) was \$100 per share. The bargain element is \$98 per share (\$100 FMV - \$2 option price). Joe bought 10,000 shares for \$20,000 with the ISO. Joe has to add \$980,000 (\$98 bargain element per share times 10,000 shares). Did Joe have to pay AMT? He sure did. Note that Joe has a basis of \$20,000 in the stock for

regular tax purposes and \$1 million for AMT purposes. Fast forward to 2000. You tell Joe on April 15, 2000 that he owes \$275,000 because of AMT on his ISO. Joe thinks you're an idiot. After all, how can you owe tax on money you never got? So, he goes down the street to the Big Box tax office. He doesn't show them his ISO paperwork and gets a \$1000 refund. The IRS comes a knockin' in 2001. They tell Joe he owes \$276,000 plus interest and penalties. In the meantime, Joe's stock became worthless in 2001. He has a loss of \$20,000 for regular tax purposes and \$1,000,000 for AMT purposes. Joe can file a Form 8801 for 2001 to get an AMT credit against his 2001 tax liability since AMT on his ISO is due to a timing difference (between when regular tax and AMT is due on the transaction), not an exclusion. However, he still has to pay the \$276,000 for 2000 (plus penalties and interest). Will Joe's 2001 AMT credit be anywhere near what he owes for 2000? It's highly unlikely.

**Basis Adjustments:** This term doesn't explicitly appear on Form 6251, the form used to calculate AMT. Basis is your investment in an item for tax purposes. Because of the convoluted AMT rules, you can have a different basis in the same item for regular and AMT tax purposes. This can lead to a different gain or loss for AMT and regular tax purposes. This generally only affects the sale of business assets (including rental property) and the sale of stock acquired via an ISO, as in the ISO example above. This general rule affects several lines in the Form 6251.

**Depreciation:** This could affect taxpayers who are landlords or run businesses (for example, self-employed taxpayers). It turns out there are often differences between the amount of depreciation allowed for regular tax purposes and for AMT purposes. In most cases, you get less of an upfront deduction for AMT purposes

in early years. Even under AMT rules, you get to fully deduct your basis in the asset if you use it long enough for business. That means you'll have a positive adjustment for depreciation early in the life of a business asset (your AMTI will increase because of this item) and a negative adjustment (decrease in AMTI) late in the life of a business asset. For example, say you bought a machine for \$5000 with a 5-year life for both AMT and regular tax purposes. In most cases, the first-year depreciation for regular taxes will be \$1000 (not counting the 30% or 50% additional depreciation, which is allowable for AMT purposes). It will be \$750 for AMT. The \$250 difference gets added to regular tax AGI when calculating AMTI. In effect, you'll get it back at the end of the asset's life when AMT depreciation exceeds regular tax depreciation. Note that if you take the additional 50% depreciation on this item, the basis for regular depreciation is \$2500. Regular tax depreciation is \$500, and it's \$375 for AMT for an upward adjustment of \$125 (\$500 - \$375). The additional depreciation obviously reduces AMT exposure.

No doubt your eyes are rolling and you have a headache by now. So, I won't go into any of AMT rules that are really esoteric and that affect only a small number of people. The 1999 Joint Committee on Taxation study mentioned above has a succinct explanation of these items.

[Note: I didn't update this example to take the new 2003 tax law into account. However, the principles it illustrates are still valid.] Now let's look at an example that would not be unusual if the stock market were still going up, as I'm sure it eventually will again. Say a married couple with 6 dependent kids, \$90,000 of regular adjusted gross income (including a \$500 state tax refund), and \$10,000 of capital gains (none are qualifying 5-year gains) for a regular tax AGI of \$100,000. Assume they had \$9000 of medical expenses (\$1500 of which are deductible for regular tax purposes, as shown above), \$8000 of taxes, \$7000 of mortgage interest, \$2000 of charitable contributions, and \$3000 (after subtracting 2% of regular tax AGI) of miscellaneous itemized deductions subject to the 2% floor. The total itemized deductions are \$21,500. So, line 39 of Form 1040

(starting point for calculating AMTI) is \$78,500 (\$100,000 AGI minus \$21,500 of itemized deductions). Their personal and dependent exemptions for 2002 are \$24,000 (8 x \$3000 per exemption). Their taxable income is \$54,500 (\$100,000 – \$21,500 – \$24,000). Their regular tax for 2002 would be \$7859.

For AMT purposes, add back the \$1500 medical deduction, \$8000 deduction for taxes, and \$3000 miscellaneous deduction to regular tax AGI. Subtract the \$500 state tax refund. This leads to \$90,500 of alternative minimum taxable income (AMTI) (\$78,500 + \$1500 + \$8000 + \$3000 – \$500). The AMT exemption is \$49,000. Subtracting \$49,000 from \$90,500 leaves \$41,500 as the base for calculating AMT. It turns out that AMT capital gains tax in this case is the same as the regular capital gains

*taxable* incomes (not gross income, which is higher than taxable income because of deductions) above \$112,850 (married, filing jointly), \$67,700 (single), and \$96,700 (head of household). The bottom rate for AMT is 26% of the first \$175,000 of the AMT taxable amount (AMTI less the allowable AMT exemption amount and excluding capital gains) and 28% of the amount in excess of \$175,000. Note that the 26% AMT rate is significantly larger than the 10% and 15% tax rates the married couple in my example paid on their regular taxable income (excluding the tax on the capital gains). That's why they got hammered.

### Lessening the Effects of AMT

Substitute "client" or "taxpayer" for "you" in the following, as applicable.

So, what can you do about it? If your

in the dumper, sell it before the end of the year. If you exercise an ISO and sell the stock in the same year, no AMT adjustment is required.

Of course, there is a reason you wouldn't want to do this. If you hold the stock a year and a day after you exercise the option (and if the total combined holding period for the option and the stock is more than 2 years after the ISO was issued to you), you pay tax on your profit at the lower capital gain rates (instead of ordinary income rates). However, if the bargain element is very large, as in my example above, I'd probably strongly recommend to clients that they not take the risk of holding the stock long enough to qualify for the capital gains rate. I'd recommend that clients at least sell enough stock to pay the tax bill. They could still

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tax (works out to \$1780 because some of the capital gains are taxed at 10% and some at 20% because of this hypothetical couple's income). When you crunch the numbers, this couple would owe an AMT of \$2111 for 2002 for a total tax of \$9970!

Did they have any unusual tax deductions? Obviously, no. So what was their sin? They had eight (2 personal and 6 dependent) exemptions and paid a lot of state income taxes and property taxes. It turns out capital gains didn't hurt them in this example. If they'd taken the standard deduction and didn't have any kids, they wouldn't have owed any AMT, but their regular tax would have been higher. High capital gains that are a large part of a taxpayer's income can increase AMT by reducing or eliminating the AMT exemption amount, which is what happened in my example at the beginning of this article.

So, why does this happen? For two main reasons: (1) AMTI is almost always higher than regular taxable income because of all the "stuff" that's disallowed for AMT purposes and (2) AMT tax rates are higher than regular tax rates except for very high income people, those with 2002

income and deductions are pretty much the same from year to year, probably not a lot. However, if your income is unusually high for one year, take a look at the deductions you can control and pay the expenses in the year that's to your best advantage. Spread your income out, or accelerate it, or defer it if you can.

For example, pay property taxes and make charitable contributions in December, instead of January (or vice versa). Accelerate or postpone paying medical bills to the extent you can (if you itemize and have enough medical and dental expenses to deduct some of them). Pay professional dues, financial planners, etc. (examples of miscellaneous itemized deductions) in the year that's to your best advantage, where possible.

Time stock and mutual fund sales to minimize AMT. Be careful with this one. Tax savings could be dwarfed by investment gains and losses. From a tax point of view, it's best to save this for the end of the year.

If you qualify, exercise incentive stock options (ISO) at the beginning of the year. Exercising an ISO means you buy the stock at the option price. If the stock goes

roll the dice on the rest of the stock if they think it's a good investment.

This can be a lot of work, but you could save thousands of dollars with proper planning. My suggestion is to complete Form 6251 and see how close you are to owing AMT. You might be unpleasantly surprised at the (potentially) small difference between your regular and alternative minimum tax. Unless Congress changes the law, the problem will get worse. Regular tax rates, the standard deduction, and exemptions are indexed to inflation. AMT exemption and tax rate are not indexed to inflation. In addition, the standard deduction and 15% tax bracket for married couples is now double the amounts for single people. That's not true for AMT. So, even if you're not affected now, that doesn't mean you won't be affected in the future.

### Conclusion

About 25% of taxpayers will pay AMT in 2010 if tax laws don't change (up from about 2% for the 2001 tax returns filed in 2002). I'd expect that number to include many of our clients. **EA**