

## *Alternative Minimum Tax – A Trap for the Unwary*

In last month's article, the computation of the alternative minimum tax (AMT) and some of the most common deferrals and exclusions, also called preferences and adjustments, were addressed. However, an examination of the preferences and adjustments does not tell the whole story. High income taxpayers are often not subject to AMT, but the number of moderate and lower income taxpayers subject to the AMT has skyrocketed. This article will explain how people get trapped by the AMT and how to avoid this fate.

A basic reason for the application or non-application of the AMT is the difference in the tax rates for regular and AMT purposes. If a taxpayer has a substantial amount of ordinary income which is subject to the higher regular tax rates, then the difference between the taxpayer's average regular tax rate and the AMT tax rates will be large and, even with a substantial amount of AMT exclusion items and the phase-out of the exemption from AMT, will not cause the tentative minimum tax to exceed the regular tax. It is the moderate and the low-income taxpayers that get trapped by the AMT.

One of the biggest reasons for taxpayers becoming subject to the AMT is a large amount of income that is subject to both the AMT and regular tax at the same rate. Most often a substantial long-term capital gain causes the problem. Such a capital gain causes a taxpayer's alternative minimum taxable income (AMTI) and adjusted gross income (AGI) to be quite high. This causes the exemption for AMT to be substantially or completely phased out. Because the tax rates applied to a long-term capital gain are the same for AMT and regular tax purposes, the preferences, most particularly state income taxes on the large gain, cause the AMT tentative tax to exceed the regular tax.

An example may serve to illustrate the above. In a "normal" year, the Joneses have wages of \$100,000, qualified dividends of \$3,000, taxable interest of \$2,000, real estate taxes of \$5,000 and pay state taxes at a 5% rate. Their total federal tax for a "normal" year would be about \$14,500 and they would not be subject to AMT. Let's now suppose that they realize a long term capital gain in the amount of \$200,000 and must pay state taxes of \$10,000 relative thereto.

### **Conventional Tax Planning Doesn't Pay**

The Joneses believe that, if they pay the state tax due on the gain prior to year end, it will save them federal tax as state taxes are deductible. Consequently, they pay the \$10,000 of state tax on December 31 and calculate their federal tax to be about \$62,000. However, to their dismay, the Joneses do not benefit from the pre-payment of the state tax because they were subject to AMT as a result of the long-term capital gain.

Conversely, if the Joneses had done some AMT planning, they would have realized that there was no benefit to paying the state tax early and they could have held the \$10,000 for an extra three and a half months, from December 31 through April 15<sup>th</sup>,

the due date of the state tax. Moreover, if they paid the state tax in the subsequent year, they would have been entitled to a deduction (as they would be back to a “normal” year) and they would have saved \$2,500 in federal tax. The Joneses could have avoided the sting of the AMT with some planning.

To plan for the AMT, one must think both in terms of those rules and the regular tax rules. In the case of the Joneses, the computation would have been more complicated if a portion of the state tax on the gain would have been deductible in the earlier year. However, in such a case, a computation of the amount of the maximum state tax deduction could have been done and they could have paid only that amount. Another means by which the Joneses could have avoided the AMT is to have spread the large capital gain over the two years, trying to stay under the AMT threshold in each year. This is not always an alternative, though.

### **Tax Avoidance**

The AMT trap can be avoided in the case where an unusually large amount of ordinary income is to be realized in a year by bundling AMT adjustment items in the high income year. For example, suppose that Mr. Smith is either subject to AMT or quite close to it in a “normal” tax year, but he knows that next year he will receive a large bonus. He should attempt to defer items such as state income taxes, real estate taxes, excise taxes, and unreimbursed employee business expenses as they will not save tax in a “normal” year because each is an AMT Adjustment.

If Mr. Smith pays these items in the “bonus” year, these regular tax deductions bring the calculated regular tax down, but have no impact on the AMT calculation. Because the “bonus” is taxed at ordinary income tax rates, which exceed the two AMT tax rates of 26% and 28%, the regular tax may still exceed the AMT tentative tax; therefore, Mr. Smith may receive full benefit for the items paid and avoid the AMT trap. The same holds true for expenses that Mr. Smith knows he will have to pay in the year following the “bonus” year. If he pays some early, his regular tax in the “bonus” year may be reduced.

AMT planning is no more difficult than regular tax planning, but it is often counter intuitive. It requires one to understand the differences between the two tax systems and how an item, even though treated the same under each set of rules, can cause AMT. There are additional limitations on one’s ability to manipulate the timing of payments that must be considered; therefore, as always, I recommend that you consult with a competent professional who practices in this area.

*The author of this article, Joseph G. Imbriani, Esq., CPA/PFS, practices in the areas of taxation and estate planning and is a partner of the Boston law firm of Taylor, Ganson & Perrin, LLP.*