

Alternative Minimum Tax – A Trap for the Unwary

The alternative minimum tax (AMT) was enacted by Congress so that individuals with large income and large offsetting deductions would have to pay their fair share of income taxes. However, 3.3 million taxpayers were subject to the tax in 2003 and a projected 46 million taxpayers will be subject to the tax in 2014. The tax has clearly outlived its useful life, but the cost to repeal the tax has been estimated at \$100 billion per year, an amount of tax revenue that the federal government can not afford to lose. Thus, we are stuck with the AMT, so we may as well try to understand it and design a tax plan to eliminate (or at least) minimize the application of the same.

The AMT calculation starts with adjusted gross income less itemized deductions to which various adjustments and preferences are applied to determine the alternative minimum taxable income. Then, the exemption for AMT purposes is deducted. The exemption for a single person was \$40,250 for 2003, but is reduced when a single taxpayer's AMT income exceeds \$112,500. The exemption is completely eliminated at AMT income of \$273,500.

Legislative Update

The AMT exemption was to be reduced to \$33,750 for a single person for 2004 because the statute that increased it was set to expire. As of this writing, Congress passed the *Working Families Tax Relief Act of 2004* which extends the increased AMT exemptions through 2005. The President has not signed this bill into law yet, but he is expected to do so shortly.

After the exemption is deducted, the tentative minimum tax is calculated by applying the tax rates of 26% and 28% (except in the cases of qualified dividends or long term capital gains to which the same reduced tax rates, usually 15%, that are used for regular tax purposes, are applied). The computed tentative minimum tax is compared to the regular tax and the excess of the former over the latter, if any, is the alternative minimum tax.

The adjustments made to compute AMT fall into two categories, temporary differences (also called deferrals) and permanent differences (also called exclusions). An example of a temporary difference is the taxation of an incentive stock option (ISO). For regular tax purposes, the exercise of an ISO is not a taxable event. Only the subsequent sale results in a taxable event, the recognition of a long term capital gain equal to the difference between the exercise price and the sales price.

Conversely, for AMT purposes, the exercise of an ISO results in a taxable event, an adjustment equal to the difference between the exercise price and the fair market value (FMV) at the date of exercise. Additionally, the sale of the stock will trigger a capital transaction equal to the difference between the FMV at exercise and the sales price.

Incentive Stock Option Example

An example will illustrate how a temporary difference can result in an AMT nightmare. An executive exercised ISOs at a cost of \$100,000 when the FMV of the stock obtained equaled \$500,000 and then two years later sold the stock for \$700,000. For regular tax purposes, nothing happened in the year of exercise and in the year of sale a long term capital gain of \$600,000 (\$700K - \$100K) was recognized. For AMT purposes, in the year of exercise, an adjustment was realized in the amount of \$400,000 (\$500K - \$100K) and a capital gain was recognized in the year of sale in the amount of \$200,000 (\$700K - \$500K). Thus, for each of regular tax purposes and AMT purposes, a total of \$600,000 was reported as income, but the timing was different.

The timing however causes the AMT nightmare. In the year of exercise, the AMT adjustment likely generated \$100,000 in AMT. The AMT paid on a temporary difference can be used as a credit in subsequent years, but only to the extent that regular tax exceeds AMT; thus, it often takes years to enjoy the benefit of the credit. To add to the misery, the executive may not have had the cash to pay the tax as he held the stock to qualify for the favorable long term capital gain tax rate upon the sale.

The other type of difference between regular tax and AMT, permanent differences (or exclusions), have much broader application. Some of the adjustments that impact the majority of taxpayers who are currently and are projected to be subject to the AMT are addressed below.

Taxes

State income, real estate, excise and other types of taxes are not deductible for AMT purposes.

Miscellaneous Itemized deductions subject to 2% of AGI

These deductions are not permitted for AMT purposes.

Medical Expenses

For regular tax purposes, such expenses are deductible to the extent they exceed 7.5% of AGI. For AMT purposes, the threshold is increased to 10% of AGI.

Home Mortgage Interest

For regular tax purposes, the interest on a home equity loan (up to \$100,000) is deductible regardless of the use of the proceeds. For AMT purposes, mortgage interest is only deductible on loans used to purchase or improve a main or second home. Interest on refinanced amounts in excess of the original loan is not deductible for AMT purposes.

For a high income taxpayer, these exclusion amounts can be quite large, but often such taxpayers have high levels of income that are subject to regular tax rates up to 35%. Such taxpayers often avoid AMT because their marginal regular tax rate exceeds their marginal AMT tax rate by 7%. As will be discussed in next month's article, it is the exclusion items paid by the moderate and lower income taxpayers that cause them to be trapped by the AMT. Next month's article will build on the background set forth above and will address the heart of the matter, how to avoid being trapped by the AMT.

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