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DEMYSTIFYING THE ALTERNATIVE MINIMUM TAX

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A Guide to Common Triggers and Planning Strategies

The month of February is upon us, marking the start of the tax compliance season in the United States. As millions of taxpayers prepare to file their returns, many individuals - across a variety of income levels - will find themselves subject to the Alternative Minimum Tax - commonly referred to as the "AMT". This article will outline the history of the AMT, provide a high-level summary of how it operates, and identify planning strategies designed to mitigate one's exposure to AMT.

Legislative history

The AMT can be traced back to 1969, when Treasury Secretary Joseph Barr announced that 155 high income households did not have an income tax liability due the variety of deductions and credits claimed on their tax returns. Congress responded by creating an alternate tax system that disallowed many deductions and credits to ensure that high income taxpayers pay least a "minimum" amount of tax. Although the legislative intent of this new minimum tax system was clear, Congress failed to index the AMT for inflation, a decision that has gradually caused more and more middle and upper-middle income taxpayers to be subject to this tax over the past 3 decades. The AMT is now a critical revenue raiser for the Department of Treasury and its vast footprint has made fundamental reform politically and fiscally challenging.

How does it work?

The AMT is a parallel tax calculated separately from a taxpayer's regular tax liability. The computation (done on Form 6251 of one's tax return) begins with a taxpayer's regular taxable income and makes a variety of modifications (known as preferences or adjustments) based on the rules of the AMT system. The most common modifications for Minnesota residents with investment income include the disallowance of taxes deductible on Schedule A, miscellaneous itemized deductions (investment advisory, attorney, and tax preparation fees), as well as personal exemptions. The resulting alternative minimum taxable income (AMTI) is then reduced by an allowable exemption, with the balance subject to the AMT rates (26% on the first $175,000 of AMTI for MFJ filers, 28% on AMTI over $175,000 for MFJ filers). If this "tentative minimum tax" exceeds one's regular tax, the excess of the tentative minimum tax over the regular tax is the AMT. It is important to note that long-term capital gains are taxed the same for regular and AMT purposes (a maximum rate of 15% in 2012). This calculation is illustrated below and continued to next page:

1	Starting Point	Regular Taxable Income
2	Plus/Minus	ATM Adjustments & Preferences
3	Less	AMT Exemption ($78,500 for MFJ taxpayers in 2012)
4	Equals	Tentative Minimum Taxable Income
5	Times	AMT Tax Rates (26%, 28%)
6	Equals	Tentative Minimum Tax

7	Less	Regular Tax
8	Equals	Alternative Minimum Tax

Common AMT Triggers - Performing a Self Diagnosis

Although the list of AMT modifications is very extensive, there are number of preference items that increase a taxpayer's exposure to AMT. Understanding the nuances of your particular tax situation is the first step towards analyzing your exposure to AMT. You may be particularly prone to AMT if the following scenarios are present on your tax return:

- ***Taxes***: Taxes that are deductible (state income taxes, real estate taxes, sales tax, and personal property taxes) are not allowed for AMT. Thus, taxpayers residing in high tax states (such as California, New York, and Minnesota) have a greater likelihood of falling subject to AMT.

- ***Dependents****:* Since personal exemptions are not allowed for AMT purposes, taxpayers with a large number of dependents (most commonly one's children) often face heightened exposure to AMT.

- ***Miscellaneous Itemized Deductions:*** Under the AMT regime, the group of expenses classified as "miscellaneous itemized deductions" - a group that includes investment advisory fees, tax preparation fees, attorney fees, and unreimbursed employee business expenses - are not deductible for AMT purposes. Thus, taxpayers that have a substantial number of miscellaneous itemized deductions have more exposure to AMT.

- ***Private Activity Bond Interest****:* Tax-exempt interest from private activity bonds is taxable for AMT purposes. Thus, taxpayers with portfolios that contain substantial exposure to municipal bonds may find themselves more susceptible to AMT relative to other investors.

- ***Home Equity Interest Expense:*** Home equity interest that is not used to acquire or substantially improve a primary or secondary residence is not deductible for AMT purposes.

- ***Incentive Stock Option Exercises***: Taxpayers with incentive stock options (ISOs) from their employers will trigger an AMT adjustment upon exercise (the difference between the FMV and grant price at the time of the exercise is added to a taxpayer's AMTI.

The above list is not exhaustive, and the presence of one (or multiple) factors does not necessarily mean that one will be subject to AMT.

Planning for the AMT

Planning for AMT has become increasingly difficult, but there are a number of strategies that one can employ to reduce one's exposure to AMT:

- **Analyze timing of tax payments**: If you are making quarterly estimated payments, considering deferring your 4th quarter payment until January of the following year if you are going to be in AMT in the current year. The same strategy could be employed for real estate taxes as well.

- **Develop a multi-year plan:** If you expect to be subject to AMT in the current year, but in a regular bracket the next year, consider accelerating ordinary and short term capital gain income and deferring certain deductions (those that are not allowed under AMT purposes). This approach is contrary to typical tax planning, but it may reduce your tax bill by maximizing the value of your deductions.

- **Home Equity Debt and Private Activity Bond Interest:** Consider paying off home equity debt whose proceeds were not used to acquire or substantially improve your primary or second residence. In addition, if you have tax-exempt bonds in your investment portfolio, talk to your investment advisor about reducing your exposure to private activity bonds since the income these bonds generate is taxable for AMT purposes.

- **ISO Planning:** Another technique to consider is whether any stock obtained by exercising ISOs should be disqualified before the end of the year to reduce AMT liability if the stock has dropped in value. A "disqualifying disposition", in which the stock exercised is also sold by the end of the calendar year, will limit compensation income to the difference between the exercise price and the lower value of the stock at sale.

Looking Forward

With the passage of the American Taxpayer Relief Act on January 2, 2013, Congress shielded many families from AMT that otherwise would have fallen victim to it. Nevertheless, the AMT is a complex portion of the tax law that will continue to plague taxpayers across all demographics until fundamental tax reform takes place. If you would like White Oaks Wealth Advisors to help you assess and plan for AMT, please contact us at 612 455 6900.

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