White Paper

The AMT Horror

The Alternative Minimum Tax (AMT) was originally designed to prevent extremely wealthy individuals from skirting their income taxes. Unfortunately, the AMT has grown into a tax trap that haunts millions of Americans each year. But with some understanding and foresight, it is possible to make the AMT work to your advantage.

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In the 1979 film *The Amityville Horror,* George and Kathy Lutz (played by James Brolin and Margot Kidder) are plagued by various supernatural phenomena after they move into a new house. Many American taxpayers also find themselves beset by mysterious forces when they try to understand the Alternative Minimum Tax (AMT) and the unpleasant twists it brings to their finances.

The purpose of this paper is to explore the background of the AMT and to provide potential solutions for taxpayers in a variety of situations so that they don't find themselves surprised by an "AMT Horror."

The AMT started out very innocently as a way to prevent wealthy individuals from paying very little or no tax. But over the years the AMT hasn't been adequately adjusted for inflation, so the AMT affects greater numbers of people each year. In 1970, approximately 19,000 individuals paid the AMT. In more recent years, it is estimated that between 2.5 and 3 million people are caught in the AMT tax trap.

The AMT system is a parallel tax system. While most individuals are familiar with the ordinary income tax and deductions that are allowed, you may find yourself crossing over to the AMT system, a mysterious place where the rules operate very differently. But if you take the time to understand the AMT and how it differs from ordinary income taxes, you will find that it presents many tax issues and opportunities. You might even find a happy ending among all the horrors.

While one could take the time to figure out a variety of different scenarios based on various examples from the tax tables, our experiences have shown that this is less effective in illustrating the AMT, because the AMT comes into play due to a wide variety of different issues for each individual taxpayer.

In more recent years these individual situations have been further complicated by the fact that Congress has legislated lower income tax rates, but the AMT has not been adjusted for inflation since 1986. This combination makes the AMT applicable to even more taxpayers.

From a political standpoint, it would be wise for Congress to adjust the AMT exemptions and rates to reflect their current economic impact and the number of people that are being affected by this insidious tax. Unfortunately, I feel that this is unlikely because the AMT currently brings in a fair amount of revenue, and members of Congress who attack this problem run the risk of appearing to favor the wealthy. However, it is clear that the AMT has gone far beyond the intent of the original tax policy when it was first put into effect.

In order to understand the current effects of the AMT, we will consider the tax from three angles. First we will look at how to determine your AMT and the applicable tax rates. Next, we will examine the specific issues that trigger the AMT and what to watch out for in each area as you look ahead to your tax year. Finally, we will consider solutions that may be appropriate when dealing with the AMT issue.

How to determine your AMT

Basically, the AMT is a two-tiered tax structure. To determine the AMT, you first need to calculate your gross income, and then determine any applicable deductions. Many of the standard deductions from ordinary income taxes are reduced or eliminated when determining the AMT. These deductions and other factors will be identified in greater detail later in this paper. Once the applicable AMT deductions have been subtracted from your gross income,

you can see if the AMT exemption is applicable. The AMT exemption is designed to exclude taxpayers with modest incomes from the AMT, but the exemption phases out for individuals with higher incomes.

Once these items have been calculated and you have determined that you are not exempt from the AMT, then your tax is determined by the two-tiered grade: 26 percent of the first $175,000 of income and 28 percent of the excess.

The resulting AMT calculation is compared to the amount of your regular tax and you are required to pay the higher amount. The difference between a regular tax and the AMT is the amount of the AMT-specific tax. This amount is important because you may be eligible to receive an AMT credit on future taxes. This credit can be claimed on Form 8801. It requires a third calculation of your income taxes to determine the amount of available credit, if any.

Issues that trigger the AMT

A wide variety of factors can cause an AMT liability. If you are aware of these factors during the year, you can look out for events that may result in additional taxes that aren't immediately evident on ordinary income tax tables. There are basically ten things that have the potential to trigger an AMT situation.

1. Personal exemptions. The actual personal exemptions that you claim for yourself, your spouse and your dependents are not allowed when calculating the AMT. It is actually possible—believe it or not—to trigger the AMT just by having a large number of dependents in your household, although it is unlikely.

2. Standard deduction. There are a number of taxpayers who claim the standard deduction only because they don't have enough other deductions from charitable contributions, mortgage interest, real estate taxes, etc. But this isn't allowed under the Alternative Minimum Tax. And so when calculating the AMT, the standard deduction is no longer considered. As the margin between the AMT and the regular tax rates have narrowed, this alone has caused many more individuals to face the AMT problem.

3. Disallowance of state and local taxes. This area is particularly troublesome in high tax states like Minnesota where this deduction is often significant and unavoidable. An individual with lots of personal exemptions, an expensive house and a high income could be put into an AMT situation automatically.

4. Interest on second mortgages. You can deduct interest on mortgages used to buy, build or improve your home, but the interest deduction is not allowed if you borrowed on the home for another purpose. So home equity loan financing that is no longer deductible can act as a trigger for AMT tax purposes. It's complicated further in Minnesota in that the mortgage deduction is denied entirely and does not allow full charitable contributions.

5. Medical expenses. The amount allowed for the medical expense deduction is more limited on the AMT than that allowed under the ordinary income tax. If you have a large amount of deductible medical expenses, these could trigger the AMT as well.

6. Miscellaneous itemized deductions. These are the deductions that you list on the bottom of the front page of your return if they exceed more than two percent of your adjusted gross income. They include items like moving expenses, tax preparation fees, and investment expenses. They are not deductible under the AMT.

7. Tax credits. Certain tax credits allowed under the regular income tax are not valid when it comes to the AMT. In other words, any tax credits that may be coming from areas such as childcare will not be factored in when you calculate the AMT.

8. Incentive stock options. This is a huge area that can cause AMT problems for individuals. The difference between the market value and the exercised price on incentive stock options is included for calculation of the AMT. When the difference is large, this can cause a huge tax liability that could force the sale of a stock before it reaches long term capital gains status.

It is important to consider the timing of stock option purchases to make sure that long-term capital gains status can be reached if, in fact, the stock needs to be sold in order to pay taxes. Long-term capital gains have the same tax rate under the AMT as they do under the regular income tax system. So a long-term capital gain under the AMT calculation would have the same 15 percent rate as a long-term capital gain under a regular income tax calculation.

However, it is possible in this situation that an AMT liability could come into play because it reduces or eliminates the AMT exemption amount designed to help low income taxpayers. While the tax rate on long-term capital gains is the same, the loss of deductions may trigger an AMT issue.

9. Tax-exempt interest. Individuals in high income tax brackets often use tax-exempt interest to help reduce their income tax.

However, many tax-free bonds are not tax-free for AMT purposes. Examples of these include industrial revenue bonds that were issued by a municipality for the use of a company building by a private interest.

It's always important to check the actual status of an individual issuable bond if you are trying to avoid the AMT with municipals, but general obligation bonds are most likely to fit within this category.

Also, if a municipal bond has a higher interest rate compared to others, this often indicates an AMT tax liability. But in summary, even bonds that are not AMT safe, have interest that can be included for income tax purposes under the AMT

10. Tax shelters. Areas such as intangible drilling expenses in oil and gas drilling programs can also cause AMT liability problems. Also, if you have accelerated depreciation schedules for equipment and/or real estate, these can be added as income for AMT calculation purposes.

Finding opportunities in AMT tax liabilities

If you know that the AMT is going to apply to you in current or coming years, it is possible to take advantage of certain situations. Too often a taxpayer becomes aware of their AMT liability when they are filing their taxes and opportunities to mitigate the situation have passed. Paying a higher amount of taxes than you expected is never pleasant, but the AMT does present some opportunities to recognize various taxable events and improve your overall situation.

The positive part of this development is that taxpayers with an AMT liability have a maximum tax bracket of 28 percent. This may create an opportunity to recognize taxable income at the lowest rate applicable for the foreseeable future. For example, an executive with incentive stock options may recognize that a significant portion of non-qualified options have a maximum tax bracket of 28 percent in an AMT tax year, rather than 35 percent. This recognition of additional income raises the amount of total tax but creates an opportunity for a lower tax rate that would not be available in a subsequent year when the AMT liability isn't present.

You also have an opportunity to recognize other types of ordinary or regular income during a year with an AMT liability, such as the recognition of gain in a deferred annuity. If you have been avoiding the recognition of that gain because of a 35 percent income tax rate, the AMT liability gives you to a chance to recognize it with a 28 percent rate, and an improved investment vehicle may be chosen as an alternative. The recognition of more salary income in that particular year could also be beneficial because it's also taxed at a lower rate.

Claiming the AMT credit is another important way to mitigate the situation, as well as recognizing the amount of AMT tax payable in previous years that may be claimed in future years. Payment of the AMT on a transaction like an incentive stock option also creates a dual basis in the stock that is held. If you have paid the AMT on that stock, recognition of the gain has come into the AMT, and the ultimate sale of the stock gives you a new basis at roughly the exercise price on the day of the transaction. Of course if an AMT credit was claimed and retrieved on calculation it will affect that basis as well.

You might also take advantage of an AMT tax event year by disqualifying the disposition of some incentive stock options, recognizing the ordinary income gained in the year of the AMT issue. This is particularly valuable when the price of the stock is viewed as fairly valued by the executive, and recognition of the gain appears, or if it seems unlikely that you will be able to avoid the AMT any time in the near future. It may also be valuable to try and stagger the years when an AMT tax event occurs. If you can plan for an AMT liability in the current year, you may be able to avoid it the subsequent year, before it returns the year after that, maximizing the options valued before the expiry date.

Happy endings to the "AMT Horror"

In summary, the AMT is not a pleasant experience for anyone, particularly when it catches you by surprise. But it is possible to anticipate an AMT liability and the potential opportunities available with such a situation.

If we can help you with an AMT liability or any other issues, we would be happy to do so, and would provide you with a specific analysis based on your individual circumstances and situations.

If you would like to learn more about the financial services provided by Robert J. Klosterman and White Oaks Wealth Advisors, Inc., call us at 800-596-3579, or visit www.whiteoakswealth.com.

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