ALTERNATIVE MINIMUM TAX OF INDIVIDUALS

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"The AMT applies to taxpayers who have certain types of income that receive favorable treatment, or who qualify for certain deductions, under the tax law. These tax benefits can significantly reduce the regular tax of some taxpayers with higher economic incomes. The AMT sets a limit on the amount these benefits can be used to reduce total tax."

...IRS Instructions for Form 6251

To accomplish this goal, taxpayers are required to compute two tax liabilities, regular tax and Alternative Minimum Tax (AMT). Moreover, taxpayers are required to pay AMT to the extent that AMT exceeds their regular tax liability. In AMT, the use of certain exclusions, deductions, and credits that reduce regular tax are not allowed. A better name for Alternative Minimum tax (AMT) is ***Mandatory Maximum Tax.*** Taxpayers have no choice but to pay the higher tax.

AMT and related planning has changed dramatically since its inception. Prior to 1987, optimal planning for AMT consisted of equalizing regular tax and AMT. The 1986 Act added AMT credits and AMT basis adjustments which brought more fairness to the system. However, the price of this fairness is a level of complexity that has turned AMT planning into a nightmare. The complexity coupled with the fact that AMT is not indexed for inflation, makes it a target for change.

In her annual report to Congress in January 2007, National Taxpayer Advocate Nina E. Olson designated AMT as the most serious problem facing taxpayers both in its own right and because it symbolizes the broader problem of tax-law complexity. In the absence of AMT relief, estimates of taxpayers subject to AMT in 2007 ranged from 20-25 million (up from 3.5 million in 2006).

After a bitter battle over whether temporary AMT relief for 2007 should be paid for with other revenue raising provisions, the Tax Prevention Act of 2007 (AMT Patch) passed both chambers and was signed into law on December 26, 2007, without offsets.

Provisions of the Tax Prevention Act of 2007 impact the AMT exemption and credits allowable against AMT and are discussed later in this material. All examples reflect these last minute changes to 2007 AMT calculations.

I. STRUCTURE

AMT is computed using an alternate system. For most purposes, the **tax base** for the AMT is determined as though it were a separate and independent income tax system. For example, where a Code provision refers to a "loss" of the taxpayer from an activity, for purposes of AMT, the existence of a loss is determined with regard to the items that are includible and deductible for a minimum tax, not regular tax, purposes. However, **"transaction"** issues such as whether there has been a taxable event, or whether a particular nonrecognition provision apples, generally are determined identically for regular tax and minimum tax purposes.

In certain instances, the operation of the AMT as a separate and independent tax system is set forth expressly in the Code. With respect to the passive loss provisions, for example, § 58 provides that, in applying the limitation for AMT purposes, all minimum tax adjustments to income and expense are made and regular tax deductions that are items of tax preference are disregarded.

In other instances however, where no such express statement is made, Congress did not intent to imply that similar adjustments were not necessary. Thus, as illustrations, for AMT purposes it is intended that § 263A (requiring the capitalization of certain deprecation deductions to inventory) apply with regard to minimum tax depreciation deductions and that § 265 (relating to express of earning tax-exempt income) apply with regard only to items excludible from alternative minimum taxable income (AMTI).

A. The BASIC FORMULA For AMT Is:

Start With:	Regular taxable income before exemptions
Plus:	Adjustments and preferences
Less:	AMT NOL
Equals:	Alternative Minimum Taxable Income
Less:	AMT exemption – watch the phaseout
Equals:	Amount subject to AMT
Times:	AMT rate of 26/28% (or worksheet for capital gains/qualified dividends)
Less:	AMT foreign tax credit
Equals:	Tentative AMT
Less:	Regular tax before credits less foreign tax credit
Equals:	AMT

II. ALTERNATIVE MINIMUM TAX – INDIVIDUALS (FORM 6251)

The following pages describe the calculations of AMT for individuals by following Form 6251 (2007). Part I of the form discusses adjustments and preferences and Part II calculates AMT. The form begins with regular taxable income before exemptions) or adjusted gross income for non itemizers), adds or subtract adjustments and preferences and then calculates the AMT.

A. Adjustments And Preferences

Adjustments and preferences are described in IRC §§ 56 through 58. Some items are only positive while others may be positive or negative. Some items, referred to as *"exclusion"* items, reflect <u>permanent differences</u> in the calculation of regular tax and AMT. For example, private activity bond interest is included in income for AMT but not for regular tax purposes – ever. Other items, referred to as *"timing"* items, reflect the <u>difference in when</u> an item is recognized for regular tax and AMT purposes. For example, for an incentive stock option, the difference between the cost of stock and its fair market value is income for AMT purposes until the stock is sold.

1. Standard Deduction

Line 1 *- If filing Schedule A (Form 1040), enter the amount from Form 1040, line 41* (taxable income before exemptions) *and go to line 2. Otherwise, enter the amount from Form 1040, line 38* (adjusted gross income for non itemizers), *and go to line 7* (§ 56(b)(1)(E)).

The 2007 Form 6251 makes clear what the IRS had previously included in the instructions: taxpayers may not use the standard deduction to complete Form 1040 and itemized deductions to complete Form 6251. In fact, the instructions provide a tip that overall tax may be lowered for taxpayers subject to AMT by claiming itemized deductions on Form 1040, even if they total less than the standard deduction.

> **Note:** Itemized deductions are reduced by 3% of the excess of adjusted gross income (AGI) over certain thresholds. This reduction does not apply in calculating AMTI.

2. Medical And Dental Expenses

Line 2 *– Medical and Dental. Enter the small of Schedule A (Form 1040), line 4* (excess of deductive medical and dental expenses over 7 ½% of adjusted gross income) *or 2 ½% of Form 1040 line 38* (adjusted gross income) (§ 56(b)(1)(B)).

Medical expenses are deductive for AMT purposes to the extent that they exceed 10% of regular tax adjusted gross income. Because medical and dental expenses are deductible to the extent that they exceed 7 ½% of AGI for regular tax purposes, the adjustment for AMTI is the lesser of medical and dental expense claimed for regular tax or 2 ½% of AGI.

> **Note:** In determining AMTI for individuals, all references to adjusted gross income (AGI) are to AGI or modified AGI for regular tax purposes. This, the 2 ½ % of AGI referred to above is to regular tax AGI, not adjusted for any differences in the treatment of items for AMT purposes.

Example

Taxpayers	**Abbey**	**Bob**	**Charles**
Regular Tax AGI	$50,000	$50,000	$50,000
Medical and Dental Expense	3,000	4,000	6,000
7 ½ % of AGI	3,750	3,750	3,750
Allowed for Regular Tax	**0**	**250**	**2,250**
10% of AGI	5,000	5,000	5,000
Allowed for AMT	**0**	**0**	**1,000**
AMT Adjustment	$ 0	$ 250	$ 1,250

3. Taxes

Line 3 *– Taxes from Schedule A (Form 1040), line 9* (all taxes deducted on Schedule A) (§ 56(b)(1)(A)(ii)).

Taxes deductive only as itemized deductions, including state income tax and real and personal property tax, are not deductible for AMT purposes. Taxes deducted elsewhere on the return, such as real property taxes on a rental property, are deductive for AMT purposes.

Planning: Traditionally planning strategies related to prepayment of state income tax are usually counter productive in an AMT year. Generally, payment of state income tax should be postponed to a non AMT year in which the payment will result in a federal tax savings. However, in some cases payment of state income tax (or other taxes) is advisable in an AMT year if such payment increases the AMT credit or increases the "unused 15% tax bracket" for purposes of calculating capital gain tax. See the planning section below.

Planning: For a taxpayer with a vacation home who is subject to AMT, a larger allocation of property tax to the rental activity may be beneficial.

4. Interest

Line 4 *– Enter the home mortgage interest adjustment, if any, from line 6 of the worksheet on page 2 of the instructions* (§ 56(e)).

Included on this line is any interest (and/or points) deducted for regular tax purposes on a loan that was not used to buy, build or substantially improve the taxpayer's main home or second home (that is a qualified dwelling).

Exception: Mortgages taken out before July 1, 1982 that were secured by the taxpayer's main home or a qualified dwelling unit.

AMT and regular tax rules are very different when it comes to interest on the taxpayer's home. Regular tax permits the deduction for *qualified residence interest* (§ 163(h)(3)) whereas AMT limits the amount of deductible mortgage interest to *qualified housing interest* (§ 56(e)). So, what is the difference?

Caution: Falling interest rates have driven taxpayers to refinance and/or take out equity lines in droves. With the increased likelihood that taxpayers will be subject to AMT, special care must be given to changes in financing.

No Home Equity Loans. The primary difference is that no deduction is allowed in AMT for interest on a home equity loan unless the loan proceeds were used to substantially improve the home.

Example

Maria, a tax preparer, taxes out a home equity loan for $20,000 to spend two months in Tahiti recovering from tax season. For regular tax purposes interest on up to $100,000 of home equity indebtedness may be deducted. No similar provision exists in AMT.

> **Planning:** For regular tax purposes, if proceeds from a home equity loan are used in a business, for investment or related to a passive activity, the interest on such loan may be deductive subject to the rules applicable to the use of the borrowed funds.

Example

If Maria in the above example used the $20,000 to purchase stock, she could deduct the interest for AMT purposes to the extent that she had investment income for AMT purposes. For regular tax purposes, Maria may deduct the interest under the home equity loan rules or she may elect to trace the debt to its use and apply the investment interest expense rules.

Different Grandfather Date. Regular tax and AMT provide for different dates prior to which loans are grandfathered. For regular tax purposes, debt incurred on or before October 13, 1987 is treated as acquisition debt and is not limited to $1,000,000.

> **Caution:** Pre October 14, 1987 debt is grandfathered only for as long as the term of the loan existing on October 13, 1987 (or the earlier of the term of the first refinancing or 30 years if the loan is not amortized).

> **Note:** The debt must be secured by a qualified residence on October 13, 1987, and at all times thereafter before the interest is paid.

AMT grandfathers debt incurred before July 1, 1982. Thus, interest on a home equity loan taken out after June 30, 1982, and prior to October 14, 1987, may be deductible for regular tax purposes but not for AMT.

Boats don't count for AMT. The term "qualified residence" for regular tax purposes means the principal residence within the meaning of § 121 and one other residence used as a residence within the meaning of § 280A(d)(1). § 280A(d)(1) defines residence as a dwelling unit which includes a house, apartment, condominium, mobile home, and boat which provides basic living accommodations of a bed, bath and kitchen (Reg. § 1.280A-1(C)). For purposes of "qualified housing interest", deductible for AMT purposes, a "qualified dwelling" includes only a house, apartment, condominium or mobile home not used on a transient basis.

5. Miscellaneous Itemized Deductions

> ***Line 5** – Miscellaneous deductions from Schedule A (Form 1040), line 27* (all miscellaneous itemized deductions subject to the 2% AGI which were deductible for regular tax purposes) (§ 56(b)(1)(A)(I)).

No miscellaneous itemized deductions subject to the 2% of AGI reduction are deductible for AMT purposes.

> **Planning**: Taxpayers with substantial unreimbursed employee business expenses may lose the tax deduction for those expenses due to AMT. Reimbursement of such expenses under an Accountable Plan eliminates this problem.

> **Losses:** Remember that real IRA losses (when taxpayer has basis and all IRA funds are gone) are claimed as a miscellaneous itemized deduction subject to the 2% of AGI limitation. Similarly a real abandonment loss of investment property may not be preferable to a capital loss because it also is claimed as a miscellaneous itemized deductions subject to the 2% of AGI limitation.

6. Regular Tax Phaseout Of Itemized Deductions

> ***Line 6** – If Form 1040, line 38* (adjusted gross income) *is over $156,400* (in 2007) *(over $78,200 if married filing separately), enter the amount from line 11 of the Itemized Deductions Worksheet on page A-10 of the instructions for Schedules A (Form 1040)* (which calculates the phaseout of itemized deductions).

Itemized deductions that are lost for regular tax purposes when adjusted gross income exceeds certain thresholds are subtracted for AMT purposes. Line 6 is a negative number. Depending on a taxpayer's level of income this subtraction has tax consequences which can be contrary to conventional wisdom. See the planning section below.

7. Refund Of Taxes

> ***Line 7** – Tax refund from Form 1040, line 10 or line 21* (§ 56(b)(1)(D)).

Because taxes are not deductible in computing AMT, tax refunds are not included in AMTI. Therefore, if <u>a tax refund is included in income for regular tax purposes</u>, it must be subtracted for AMTI purposes. Line 7 of Form 6251 is a negative number.

> **Note:** Include refunds attributable to state or local personal property taxes, foreign income taxes, or state, local, or foreign real property taxes deducted after 1986.

The question is–*When is a tax refund included in income for regular tax purposes?* The problem related to state income tax is not with the calculation of AMTI but with regular tax. If the deduction for state tax paid did not result in a tax benefit, then the refund of that tax is not added to regular taxable income.

What if the taxpayer was subject to AMT for the year in which the overpayment of state taxes arose? Generally a taxpayer subject to AMT receives no current year tax benefit for the deduction of state tax paid. However, state tax paid may increase the AMT credit (see planning section below), producing a regular tax benefit in future years. Presumably, in this case, the refund of overpaid state tax is includible in income. The IRS agrees and states this position in Publication 525 (Taxable and Nontaxable Income) in the section dealing with Recoveries as follows:

> *"You must include a recovery in your income in the year you receive it up to the amount by which the deduction or credit you took for the recovered amount reduced your tax in the earlier year. For this purpose, any increase to an amount carried over to the current year that resulted from the deduction or credit is considered to have reduced your tax in the earlier year."*

8. Investment Interest

Line 8 *– Investment interest expense (difference between regular tax and AMT)* (§ 56(b)(1)(C)).

As in the calculation of regular taxable income, investment interest is deductible for AMT purposes only to the extent of investment income for AMT purposes. However, because special AMT rules apply to many items of income and deduction, investment interest expense and net investment income for AMT can be very different from those amounts for regular tax. Essentially, a separate Form 4952 (Investment Interest Expense Deduction) must be completed to determine investment interest deductible for AMT purposes. Differences in the numbers on Form 4952 may include:

Investment Interest Expense:

- Interest on a home equity loan whose proceeds were invested in stock or bonds.
- Carryover of disallowed investment interest expense from a prior year.

Net Investment Income:

- Private activity bond interest (excludible for regular tax purposes).
- Gain on sale of investment assets (for example, stock acquired via the exercise of an Incentive Stock Option).
- Portfolio management expense over 2% of adjusted gross income.

Example

I.M. Investor's investment income and expenses are as follows:

Brokerage account dividends	$10,000
Tax-exempt interest	15,000
Private activity interest included in above tax-exempt income	3,000
Portfolio management expense deductible for regular tax	1,500
Margin account interest expense	9,000
Home equity loan interest expense – proceeds used to buy stock	3,200

I.M. Investor's deductible investment interest expense is:

	Regular Tax	AMT
Net Investment Income:		
Brokerage account dividends	$10,000	$10,000
Private activity bond interest	0	3,000
Portfolio management expense	-1,500	-0
Net Investment Income	8,500	13,000
Investment Interest Expense:		
Margin account interest	9,000	9,000
Home equity loan interest	0[1]	3,200
Investment interest Expense	9,000	12,200
Deductible Investment Interest Expense	**$8,500**	**$12,200**

Negative Adjustment: If the AMT interest expense is greater than regular tax interest expense, the adjustment on line 8 is a negative number.

Schedule A and Schedule E.

Line 8 includes differences in investment interest expense on both Schedule A and Schedule E. If the taxpayer did not itemize for regular tax purposes, only adjustments to investment interest expense reportable on Schedule E are entered on line 8.

9. Depletion

Line 9 *– Depletion (difference between regular tax and AMT)* (§ 57(a)(1)).

Depletion must be recalculated for AMT. Only income and deductions allowed for AMT are used when refiguring the limit based on taxable income from the property under § 613(a) and the limit based on taxable income, with certain adjustments, under § 613A(d)(1). Also, depletion deductions for mines, wells and other natural deposits under § 611 are limited to the property's adjusted basis at the end of the year as recalculated for AMT, except for independent producers

[1] This interest was deducted for regular tax purposes as home equity debt interest (up to loan proceeds of $100,000).

or royalty owners claiming percentage depletion for oil and gas wells under § 613A(c)). This limit is figured separately for each property.

10. Net Operating Loss Deduction

> ***Line 10*** *– Net operating loss deduction from Form 1040, line 21. Enter as a positive amount.*

The regular tax net operating loss is added back on line 10. The net operating loss recomputed using AMT amounts is deducted on line 27.

11. Private Activity Bond Interest

> ***Line 11*** *– Interest from specified private activity bonds exempt from the regular tax* (§ 57(a)(5).

Interest on private activity bonds issued after August 7, 1986, reduced by any deduction attributable to them that would have been allowable if the interest were includible in gross income for regular tax purposes, is added on line 11.

Private activity bonds are bonds issued by state and local governments to provide financing for purposes other than government operations or facilities. Such bonds might provide financing for stadiums or housing projects.

> **Practice:** It is imperative to determine how much tax exempt income for regular tax purposes relates to private activity bonds for those clients subject to AMT.
>
> **Form 1099 Reporting:** Tax exempt interest paid after December 31, 2005, is subject to Form 1099 information reporting rules that apply to taxable interest pursuant to TIPRA of 2005 (§ 6049). The new rules specifically require reporting of the amount of tax exempt AMT interest (including tax exempt AMT interest paid as dividends), to the extent possible after reasonable effort (Notice 2006-93) (box 9 on the 2007 Form 1099-INT).
>
> **Exceptions:** Interest on Qualified New York Liberty Bonds and Gulf Opportunity Zone bonds described in § 1400N(a) are not subject to AMT.

12. Qualified Small Business Stock

Line 12 – *Qualified small business stock* (7% of gain excluded under § 1202) (§ 57(a)(7)).

For regular tax purposes a noncorporate taxpayer may exclude 50% of any gain from the sale or exchange of qualified small business stock held for more than five years (§ 1202(a)). Such gain is not eligible for the 15%/5% (20%/10% for sales prior to May 6, 2003) capital gain rate but remains subject to the 28%/15% rate. Because § 1202(a) excludes 50% of the gain from gross income, the effective rate on such gain is 14%/7.5%. Gain eligible for the 50% exclusion may not exceed the greater of $10,000,000 (reduced by prior years' eligible gain on the same stock) or 10 times the taxpayer's basis in the stock.

Dispositions prior to May 6, 2003: 42% of the gain excluded from gross income for regular tax purposes is an AMT preference. Therefore, 71% (42% of 50% excluded gain plus 50% included gain) of the gain is subject to AMT.

Dispositions after May 5, 2003: For dispositions of qualified small business stock after May 5, 2003, only 7% of the 50% of the gain excluded for regular tax purposes is added back when computing AMTI (§ 57(a)(7)). As a result of this change, 53.5% (7% of 50% excluded gain plus 50% included gain) of the gain is subject to AMT.

> **Small business stock:** A qualified small business is a domestic C corporation with aggregate gross assets that do not exceed $50,000,000 as of the date of issuance. The stock must be issued after August 10, 1993 and acquired by the taxpayer at its original issue (directly or through an underwriter) in exchange for money or property, or as compensation for services provided to the corporation. At least 80%, by value, of the corporation's assets must be issued in the active conduct of one or more qualified trades or businesses, generally in a manufacturing or retail business, including a Specialized Small Business Investment Company. Personal service activities, such as health, law, engineering, architecture, accounting, etc., are not qualified trades or businesses, nor are the hospitality, farming, insurance, financing or mineral extraction industries.
>
> **Rollover:** The rollover provisions of § 1045, which permit the deferral of gain on small business stock by purchasing other small business stock, should increase the use of the exclusion at § 1202.

13. Incentive Stock Options

> ***Line 13** – Exercise of incentive stock options (excess of AMT income over regular tax income)* (§ 56(b)(3)).

Under an incentive stock option plan, an employee is granted the right to purchase the stock of his or her employer. The difference between the cost of the stock to the employee (the option price) and its fair market value provides incentive compensation to the employee. An option satisfying the requirements of § 422 qualifies as an incentive stock option (ISO) and receives the tax-free exercise treatment afforded by § 421.

Well, almost tax-free treatment! While the exercise of an ISO is not a taxable event for regular tax purposes, it does result in income for AMT purposes. The bargain element (the spread between the fair market value and the option price) at exercise is added to AMTI, even though it is not added to regular taxable income. If the stock acquired by the exercise of an ISO is sold during the same year as the exercise, there is no AMT adjustment.

> **Practice:** Determining that ISOs have been exercised but not sold is essential. Too often employees are told that exercising ISOs is not taxable so why should they inform their tax preparer of this exercise? Frequently, however, the exercise does result in tax – AMT. Even if no tax results, tracking AMT basis is necessary to properly report the sale. **ASK!**

> **Basis:** The AMT tax basis in stock acquired by the exercise of an ISO is generally its fair market value at the time of exercise. Thus, the sale of such stock results in another AMT adjustment.

Example

Joe is granted an ISO to purchase 10,000 shares of OE (Old Economy) at $0.10 per share. OE slugs its way through the downturn and eventually climbs to a value of $10.10 by July 1, 2007, when Joe exercises his ISO. The exercise creates a bargain element of $100,000 (10,000 shares *$10 ($10.10 value less $0.10 cost)). For simplicity sake, assume that Joe has $80,000 of wage income and no itemized deductions. His regular tax and AMT tax for the year of the exercise are as follows:

	Regular	**AMT**
Wages	$80,000	$80,000
ISO Bargain Element	0	100,000
Standard Deduction	(5,350)	
Exemption	(3,400)	(44,350)
Exemption Phase-Out	0	16,875
Taxable Income	71,250	152,525
Tax/Tentative AMT	14,243	39,657
Less Regular Tax		(14,243)
AMT		$25,414

14. Beneficiaries Of Estates And Trusts

***Line 14 –** Estates and trusts (amount from Schedule K-1 (Form 1041), box 12, code A).*

Any differences between regular tax and AMT flowing out from estates and trusts are entered on line 14.

15. Electing Large Partnerships

***Line 15**–Electing large partnerships (amount from Schedule K-1 (Form 1065-B), box 6).*

Certain large partnerships may elect to be "electing large partnerships" beginning in 1998. Electing large partnerships are subject to a simplified reporting regime in which many items are taken into account at the partnership level rather than being passed out to the partners separately.

An electing large partnership separates AMT adjustments into passive and other adjustments and passes out these two net numbers on Schedule K-1 (Form 1065-B). The net passive AMT adjustment (box 5, Sch K-1, 2006 Form) goes on line 18 described below. The net other AMT adjustment (box 6, Sch K-1, 2006 Form) goes on line 15.

16. Disposition Of Property

Line 16 *– Disposition of property (difference between AMT and regular tax gain or loss)* (§ 56(a)(7) and § 56(b)(3)).

When the tax basis of an asset is different for regular tax and AMT purposes, an adjustment must be made to AMT to reflect this difference for the year in which the asset is disposed. Similarly, this basis difference may generate different capital loss carryovers, necessitating adjustments in years after the disposition. Examples of when basis may be different include assets for which different depreciation deductions have been taken and incentive stock options.

Example

Lou Landlord calculates his adjusted gain from the sale of a residential rental he purchased in 1998 as follows:

	Regular	AMT	Adj
Net sales price (after selling expense)	100,000	$100,000	
Basis:			
Cost	60,000	60,000	
Accumulated depreciation	12,727	8,750	
Adjusted basis	47,273	51,250	
Gain	$ 52,727	$ 48,750	$(3,977)

Gains or losses reported on Form 4797 (Sales of Business Property), Form 1040 – Schedule D (Capital Gains and Losses), Form 4684 (Casualties and Thefts) or as ordinary income must be recalculated to reflect the AMT basis. No wonder tax returns weigh a ton!

Alert: If stock sold was acquired by the exercise of an ISO, the tax basis for regular tax and AMT is generally different. The tax practitioner must ask how stock was acquired, when completing the Capital Gains Schedule D.

Caution: The $3,000 capital loss limitation for regular tax applies separately for the AMT. In *Merlo v. Comm'r.*, 126 T.C. No. 10 (4/25/06) the Tax Court pointed out that the provisions applying to regular tax also apply to AMT unless a statute, regulation or other guidance published by the Commissioner provides otherwise. In *Norman v. U.S.* (N. Dist. Cal. 7/19/06) the taxpayer also lost the argument when the court found that § 1211, limiting capital losses to $(3,000), applies to AMT.

Example

On March 13, 2007, Fred exercises an ISO to acquire 200 shares of stock with an option cost of $20,000 when the FMV of the stock is $200,000. He pays AMT on the $180,000 bargain element at exercise. His basis in the stock after the exercise is $20,000 for regular tax and $200,000 for AMT.

On January 20, 2008, Fred sells 100 shares for $75,000 with the following results:

		Regular Tax		AMT
Sales Proceeds		$ 75,000		$ 75,000
Basis		(10,000)		(100,000)
Gain/(Loss)	(Ordinary)	$65,000	(Capital)	$(25,000)

Because Fred did not hold the stock for more than one year from exercise, the sale is a disqualifying disposition. Therefore the gain for regular tax purposes is ordinary. The loss for AMT purposes is a short term capital loss (limited to $(3,000) if Fred has no other capital gains or losses).

On July 1, 2008, Fred sells the other 100 shares for $60,000 in a qualifying disposition with the following results:

	Regular Tax	AMT
Sales Proceeds	$ 60,000	$ 60,000
Basis	(10,000)	(100,000)
Gain/(Loss)	$50,000	$(40,000)

Fred's AMT adjustments in 2008 related to the above transactions (if there are no other capital transactions) are:

	Regular Tax	AMT	AMT Adjustment
Ordinary Income	65,000	$ 0	$(65,000)
Capital Gain/(Loss) – see note	$50,000	(65,000)	(53,000)

Note: Although the capital gain/(loss) difference between regular tax and AMT is $(115,000), the net loss for AMT purposes may not exceed $(3,000). Fred has a carryover capital loss for AMT purposes of $(62,000) ($(22,000) short term and $(40,000) long term).

17. Post-1986 Depreciation

Line 17 *– Depreciation on assets placed in service after 1986 (difference between regular tax and AMT)* (§ 56(a)(1).

Differences in Depreciation Are Accounted for Elsewhere

If depreciation differences are part of an adjustment made on a different line of Form 6251, then no adjustment should be made on line 17. Examples are:

Employee business expenses. Unreimbursed employee business expenses are miscellaneous itemized deductions. Therefore, employee business expenses deducted for regular tax purposes (those in excess of 2% of adjusted gross income) are added back on line 5 above (miscellaneous itemized deductions).

Passive activities. Differences in depreciation related to assets used in passive activities are accounted for on line 18.

Activities from which losses are limited due to the basis or at-risk rules. Differences in depreciation related to assets used in these activities are accounted for on line 19.

Tax shelter farm activities. Differences in depreciation related to assets used in tax shelter farm activities are accounted for on line 26.

Property Placed in Service after 1986 and before 1999

For property place in service after 1986 (and property purchased after July 31, 1986 for which an election to use MACRS was made) and before 1999, the AMT adjustment for depreciation is the difference between regular tax depreciation and depreciation computed under the Alternative Depreciation System (ADS).

Generally, both the depreciation method and recovery period are different under ADS. ADS uses 150% declining balance for personal property and straight line for real property. The recovery period for ADS is the midpoint of the class life in the asset depreciation range as prescribed in § 167(m). For some asset or groups of assets, Congress has specifically modified the life. A comparison of the MACRS life and AMT life (pre 1999) of frequently encountered assets follows:

	MACRS	**AMT**
Automobiles	5	5
Computers	5	5
Other office equipment (includes copiers)	5	6
Cellular phones and fax machines	7	10
Office furniture	7	10
Personal property in rentals (carpets, drapes, appliances)	5	9
Unclassified personal property	7	12

Real property – residential rental	27.5	40
Real property – commercial	39	40

Property Placed in Service after December 31, 1999

The 1997 Taxpayer Relief Act confirmed the recovery periods (but not the methods) used for AMT purposes to those used for regular tax purposes for property placed in service after December 31, 1998. However, 1997 TRA did not go far enough to eliminate the AMT depreciation adjustment. For personal property placed in service after December 31, 1998, an AMT adjustment is required to account for the differences in method – 200% declining balance for regular tax and 150% declining balance for AMT. No adjustment is required for real property placed in service after 12/31/98.

A technical correction in the 1998 Act, provides for an election to use 150% declining balance method (rather than the faster 200% declining balance method available) for regular tax purposes for tangible personal property placed in service after December 31, 1998. Thus, a taxpayer willing to use the slower depreciation method (150% rather than 200%) for regular tax purposes may use the shorter recovery periods previously only available for regular tax purposes and eliminate any AMT depreciation adjustment.

Example

Frank's Functional Furniture purchases $10,000 of office furniture for its own office in March of 2007. If Frank's elects to use the 150% declining balance method for regular tax purposes, the 2007 depreciation deduction related to the furniture for both regular tax and AMT is:

$10,000/7 years x 150% x ½ (mid-year convention) = $1,071

Alternatively, Frank's may use 200% declining balance method for regular tax, producing an AMT adjustment of $358:

Regular tax:	$10,000/7 years x 200% x ½ (mid-year convention)=	$1,429
AMT	$10,000/7 years x 150% x ½ (mid-year convention)=	(1,071)
Adjustment		$ 358

30% or 50% Additional Depreciation – Between September 10, 2001 and January 1, 2005

The 30% (50% for property acquired after May 5, 2003) additional depreciation allowance (Sec. 168(k)) for property acquired after September 10, 2001 and before January 1, 2005 (January 1, 2006 for certain property with longer production periods), may be claimed for both regular tax and AMT. Generally, the additional depreciation may be claimed for new MACRS property for which the recovery period is 20 years or less.

Avoiding Depreciation Adjustments

- ❖ Section 179 (expensing) applies to both regular tax and AMT. Therefore, no depreciation adjustment is required with respect to the cost of property for which an election to expense the cost was made under Sec. 179.

- ❖ Electing ADS for regular tax purposes eliminates the need for AMT depreciation adjustments.

- ❖ Property depreciated using a method not expressed in years such as the unit of production method does not require an AMT depreciation adjustment.

18. Passive Activities

***Line 18** – Passive activities (difference between AMT and regular tax income or loss* (§ 58(b).

Gains and losses from passive activities must be recalculated using the AMT rules. This is done on a separate Form 8582 (Passive Activity Loss Limitations). The difference between the amount allowed for regular tax and AMT purposes goes on line 18.

Note: The instructions to Form 6251 state that the AMT Form 8582 is not to be filed.

What causes differences between regular tax and AMT? Differences are:

- Depreciation of assets used in the passive activity.
- Gain or loss upon the disposition.
- Carryover of suspended losses.
- Treatment of other items such as circulation expenditures from a passive activity.

Note: Adjustments for amounts posted on Schedule D, Form 4684 or Form 4797 for a passive activity are entered on line 16 rather than line 18.

Example

Assume that Linda has the following passive activity items for 2007:

Passive activity loss for regular tax purposes	$(4,125)
Depreciation adjustment in above rental	500
Adjusted gain from disposition of property	(225)

Linda enters $(4,125) on her regular tax Form 8582 and $(3,850) ($(4,125) + $500 - $(225) on her AMT Form 8582. If Linda is able to deduct the losses she will have an adjustment of $275 on Form 6251. If she is unable to deduct the losses her passive loss carryover for regular tax and AMT will be different by $275 and there is no adjustment on the current year Form 6251.

In theory, if the taxpayer has only one passive activity and is unable to deduct its losses, the difference in suspended losses will be offset by the adjusted gain or loss upon disposition.

Example

In 1998, Harry paid $100,000 for a rental property of which $40,000 was for the land and $60,000 was for the building. Harry consistently earns over $150,000 and has been unable to deduct any losses related to the property. Each year that he holds the property, his suspended losses are:

	Regular Tax	**AMT**	**Adj**
Rents	$ 10,000	$ 10,000	
Expenses	(11,000)	(11,000)	
Depreciation[2]	(2,182)	(1,500)	
Suspended loss	$(3,182)	$(2,500)	
Suspended losses: 1998 – 2007 approx.[3]:	$(31,820)	$(25,000)	$ 6,820

At the end of 2007, when Harry sells the property for $120,000, his gain for regular tax and AMT is:

	Regular Tax	**AMT**	**Adj**
Sales price	$120,000	$120,000	
Cost	$100,000)	$100,000)	
Accumulated Depreciation	(21,820)	(15,000)	
Adjusted basis	78,180	85,000)	
Gain	$ 41,820	$35,000	$ (6,820)

The AMT adjustment for suspended losses of a positive $6,820 is exactly offset by the adjusted gain upon disposition of a negative $(6,820).

Practice: When a limited partnership ultimately sells the underlying property, look for an amount in adjusted gain or loss to reflect the difference in basis for regular tax and AMT.

19. Loss Limitations

Line 19 – *Loss limitations (difference between AMT and regular tax income or loss).*

[2] $60,000 over 27.5 years for regular tax and over 40 years for AMT.

[3] Actual numbers are slightly different due to partial years of depreciation in the years of acquisition and disposition.

Gains and losses from activities to which the at-risk and basis limitation rules apply may differ for regular tax and AMT. These differences are entered on line 19.

> **Note:** Adjustments in amounts reported on Schedule D, Form 4684 or Form 4797, even if due to differences in at-risk or basis, are reported on line 16 (adjusted gain or loss) rather than 19.

20. Circulation Costs

***Line 20** – Circulation costs (difference between regular tax and AMT)* (§ 56(b)(2)).

A taxpayer who incurs circulation expenditures is not permitted to expense his or her post-1986 expenditures for AMT purposes. Instead, in computing AMTI, the taxpayer is required to amortize such expenditures ratably over a three-year period. No AMT adjustment is required if the taxpayer elects to amortize circulation expenses over a three-year period for regular tax purposes.

If a taxpayer has a loss on property for which circulation expenses have not been fully amortized for AMT purposes, the AMT deduction is the smaller of (1) the amount of the loss allowable for the expenditures had they remained capitalized, or (2) the remaining expenditures to be amortized for AMT.

21. Long-Term Contracts

***Line 21** – Long-term contracts (difference between regular tax and AMT)* (§ 56(a)(3)).

Generally, the percentage-of-completion method at § 460(b) must be used to determine income from any long-term contract for AMT purposes. Home construction contracts, described at § 460(e)(6), are excepted. For contracts excepted from the percentage-of completion method for regular tax by § 460(e)(1), the simplified procedures for allocating costs outlined in § 406(b)(3) are used to determine the percentage of completion.

22. Mining Costs

***Line 22** – Mining costs (difference between regular tax and AMT)* (§ 56(a)(2)).

Mining exploration and development costs, paid or incurred after 1986, that are deducted in full for regular tax purposes, must be capitalized and amortized over a ten year period for AMT. A taxpayer may elect to amortize mining costs over a 10-year period for regular tax purposes and thereby eliminate the AMT adjustment.

When a loss is sustained on a mining property for which mining costs have not been fully amortized for AMT, the AMT deduction is the smaller of (1) the loss allowable for the costs had they remained capitalized or (2) the remaining costs to be amortized for the AMT.

23. Research And Experimental Costs

***Line 23** – Research and experimental costs (difference between regular tax and AMT)* (§ 56(b)(2)).

Research and experimental costs may be deducted in full under § 174 in the year paid or incurred for regular tax purposes. However, for AMT purposes, such expenses must be capitalized and amortized over a 10-year period. A taxpayer may elect to amortize research and experimental costs over a 10-year period for regular tax purposes and thereby eliminate the AMT adjustment.

Exception: If the taxpayer materially participates (within the meaning of § 469(h)) the research and experimental costs may be fully deducted in the year paid or incurred for both regular tax and AMT.

When a loss is sustained on property for which research and experimental costs have not been fully amortized for AMT purposes, the AMT deduction is the smaller of (1) the loss allowable for the costs had they remained capitalized or (2) the remaining costs to be amortized for AMT.

24. Installment Sales

***Line 24** – Income from certain installment sales before January 1, 1987.*

The Revenue Act of 1987 bars the use of the installment method by dealers in regular tax for dispositions after 1987 and thereby eliminates the AMT adjustment. Dealers of lots and timeshares who are allowed to report gain on the installment method for regular tax if they pay the interest on the deferred tax will not be required to adjust AMTI. For non-dealer dispositions after 1986, the installment method of reporting gain is allowed for both regular tax and AMT.

25. Intangible Drilling Costs

***Line 25** – Intangible drilling costs preference* (§ 57(a)(2)).

Intangible drilling costs (IDCs) from oil, gas and geothermal wells are a preference to the extent that "excess IDCs" exceed 65% of the net income from the wells. Excess IDCs are the difference of IDCs allowed for regular tax under § 263(C)) over the amount that would have been allowed if IDCs had been amortized over a 120-month period. The AMT adjustment is avoided if the taxpayer elects to write off IDCs for regular tax purposes over 60 months.

Exception: The preference for IDCs from oil and gas wells does not apply to taxpayers who are independent producers (i.e., not integrated oil companies as defined in § 291(b)(4) and not engaged in a significant amount of either retailing or refining activity) (§ 57(a)(2)(E)). This benefit is limited if IDC preferences (calculated without regard to this exception) are more than 40% of AMTI (before deducting any AMT NOL).

26. Other Adjustments

Line 26 *– Other adjustments, including income-based related adjustments.*

All other adjustments not entered above are entered on line 26. These adjustments include:

Pre-1987 Depreciation (§ 57(a)(6)). For real property depreciated using pre-1987 rules, the adjustment is the excess of accelerated depreciation over straight line depreciation (19 years for 19 year real property and 15 years for low-income housing). For leased property other than recovery property, the preference is the amount by which regular tax depreciation using pre-1987 rules exceeds the depreciation allowable using the straight line method. For leased 10-year recovery property and leased 15-year public utility property, the preference is the amount by which regular tax depreciation exceeds the depreciation allowable using the straight line method with a half-year convention, no salvage value, and a recovery period of 15 years (22 years for 15-year public utility property).

Patron's Adjustment. Unless distributions received from a cooperative are nontaxable, the total AMT patronage dividend adjustment reported by the cooperative is included on line 26.

Pollution Control Facilities (§ 56(a)(5) and § 57(a)(6)). For regular tax purposes, the basis of a certified pollution control facility may be amortized over a 60 (or 84) month period (§ 169). For AMT purposes, the deduction is determined using the ADS system for facilities placed in service before 1999 and under MACRS using the straight line method for facilities placed in service after 1998.

Tax Shelter Farm Activities (§ 58(a)(1)(A). A tax shelter farm activity is (1) any *farming syndicate* as defined in § 464(c) or (2) any other activity consisting of farming which is a passive activity pursuant to § 469(c). Differences in gain or losses between regular tax and AMT from a tax shelter farm activity that is not a passive activity are entered on line 26.

> ***Farming syndicate:*** A farming syndicate is any enterprise (other than a C corporation) whose offering is required to be registered or more than 35% of whose losses are allocated to limited partners or entrepreneurs.
>
> **Caution:** No refigured loss is allowed, except to the extent that a taxpayer is insolvent (§ 58(c)(1)). Any refigured loss is suspended and may only be used to offset gain from the same activity or when the taxpayer disposes of the activity.

Charitable Contributions of Certain Property. A charitable contribution of property to which § 170(e) applies may require an AMT adjustment if the basis of the contributed property is different for AMT purposes.

Alcohol, Biodiesel, and Renewable Diesel Fuel Credits. If an alcohol fuel credit or the biodiesel and renewable diesel fuels credit is included in taxable income under § 87, that amount is a negative adjustment for AMT.

Related Adjustments. Items based on a limit of income other than AGI or modified AGI may need adjusting for AMT purposes due to adjustments described above on lines 8, 9, 12, 13, 15 through 25, or 26. Such items include the § 179 expense deduction, deduction for the business use of the taxpayer's home, self-employed health insurance deduction, self-employed retirement plan contributions (including Keogh, SEP and SIMPLE contributions) and IRA deductions.

Example

	Regular Tax	AMT
Net schedule C income before § 179 deduction	$ 10,000	$ 10,000
AMT depreciation adjustment	0	00
Sub-total	10,000	10,800
Allowed § 179 expense	$(10,000)	$(10,800)

The positive depreciation adjustment is entered on line 17. The negative § 179 adjustment is entered on line 26. The carryover of § 179 is different between regular tax and AMT and will most likely require another adjustment in future years.

27. Alternative Tax Net Operating Loss Deduction ("ATNOLD")

Line 27 *– Alternative tax net operating loss deduction.*

For purposes of the alternative minimum tax, net operating loss deductions are determined by using a separate computation of alternative minimum tax net operating losses and loss carrybacks and carryovers. Generally, this computation takes into account all of the differences between the regular tax and AMT.

Example

In 2007, Tony receives $50,000 in wages and incurs a loss of $70,000 from a business in which he materially participates. The $70,000 loss is net of $5,000 in depreciation not deductible for AMT. Tony's regular tax NOL and his ATNOL are computed as follows:

Wages	$50,000
Business Loss	(70,000)
Regular tax NOL	(20,000)
Add back depreciation adjustment	5,000
ATNOL	$(15,000)

ATNOL Limits

Generally, the amount of an ATNOL that may be used to offset AMTI is 90% of AMTI before the ATNOLD. However, for NOLs from tax years ending in 2001 or 2002, or taken as carryovers in those years, ATNOLs based on such losses can offset a full 100% of AMTI.

Example

Continuing with Tony above, assuming that Tony elects to forego the carryback of his net operating losses, if his AMTI in 2008 is $10,000 (before considering his ATNOL), his ATNOLD is limited to $9,000 (90% of $10,000).

Caution: An election to forego the NOL carryback for regular tax is also an election to forego the carryback for AMT purposes. A separate (or different) election is not required (or permitted) for NOLs.

Qualified Gulf Opportunity Zone ATNOLs: Special rules apply if an ATNOL that is carried back to the tax year is attributable to qualified Gulf Opportunity Zone losses as defined in § 1400N(k)(2).

Domestic Production Activity: The domestic production activities deduction impacts the calculation of the ATNOLD for tax years beginning in 2005 and beyond.

2001 and 2002. Special rules applied to ATNOLS Carried To and From 2001 and 2002

III. CALCULATING ALTERNATIVE MINIMUM TAXABLE INCOME

Line 28 *– Alternative minimum taxable income. Combine lines 1-27 (If married filing separately and line 28 is more than $207,500 (2007), see page 7 of the instructions).*

Alternative minimum taxable income is the sum of regular taxable income (before exemptions) and all of the adjustments and preferences described above, adjusted for any differences between the regular tax net operating loss deduction and the alternative tax net operating loss deduction (ATNOLD), and reduced by any itemized deductions phased out for regular tax purposes by § 68(b).

Married Filing Separately AMT Penalty

A married filing separately taxpayer whose AMTI is greater than $207,500 (in 2007) must add 25% of the excess AMTI over $207,500 up to a maximum of $33,125 (2007) (at which AMTI would be $340,000) to line 28.

A. Rate Structure And Exemption Amounts

Taxpayers are allowed an exemption in the calculation of AMT. However the exemption is reduced by 25% of the excess of AMTI over threshold amounts that vary by filing status:

FILING STATUS	EXEMPTION 2003-2005	EXEMPTION 2006	EXEMPTION 2007	PHASE-OUT BEGINS	PHASE-OUT ENDS 2007
Married joint	$58,000	$62,550	$66,250	$150,000	$415,000
Single or H of H	40,250	42,500	44,350	112,500	289,900
Married separate	29,000	31,275	33,125	75,000	207,500

Exemption Amount is a Cliffhanger

The Jobs and Growth Tax Relief Reconciliation Act of 2003 increased the AMT exemption to the amounts above for 2003-2004. Note that the AMT exemption for estates and trusts remains unchanged at $22,500. **The Working Families Tax Relief Act of 2004** extended the increased exemption for tax years beginning in 2005.

Well into the 2006 tax year, **The Tax Increase Prevention and Reconciliation Act of 2006** again increased the exemption amount by $4,550 for married taxpayers filing joint returns and by $2,250 for single taxpayers. Again the relief was short lived and applied only to 2006.

As discussed earlier, **The Tax Increase Prevention Act of 2007** (December 26, 2007) saved the day in the midnight hour for 2007 by raising the exemption to the amounts above.

AMT Tax Rates

Generally, a 26% rate applies to the first $175,000 of a taxpayer's AMTI (less the exemption), and a 28% rate applies to AMTI (less the exemption) in excess of $175,000. For married individuals filing separate returns, the 28% rate would apply to AMTI (less the exemption) in excess of $87,500.

> **Caution:** The phase out of exemptions translates to an effective rate well above the advertised AMT rates of 26% and 28%. For example, a married couple filing a joint return whose Alternative Minimum Taxable Income is between $150,000 and $415,000 (exemption phase-out range for 2007) can expect to pay up to 35% in AMT on any additional income. This is comprised of the 28% AMT rate plus 25% of the 28% to reflect the phase out of the exemption.

The Tax Increase Prevention and Reconciliation Act (TIPRA) of 2006, changes the application of the rate structure for taxpayers who are excluding foreign earned income. For tax years beginning after December 31, 2005, the AMT rate (and regular tax rate) on income after the foreign income exclusion is the rate that would have applied had the excluded income been taxed.

B. Capital Gain Rates Also Apply To Amt

Both TRA 1997 and the more recent JGTRRA '03 provide that the same capital gain rates that apply for regular tax purposes also apply for AMT purposes. If AMTI, reduced by the AMT exemption discussed above, includes capital gains, page 2 of Form 6251 must be used to compute tentative minimum tax.

> **Remember:** The AMT Schedule D, computed using gains and losses after applying the AMT rules, must be used for the Alternative Minimum Tax capital gains calculations.

Example – Cost of $200k Long Term Capital Gain

		No Capital Gain	Capital Gain
Regular:	Ordinary Income	$100,000	$100,000
	Capital Gain	0	200,000
	Itemized Deductions	(19,000)[4]	(19,000)
	Disallowed Itemized	0	2,872
	Personal Exemptions	(6,800)	(4,352)
	Taxable Income	74,200	279,520
	Regular Tax	**$ 11,404**	**$ 42,729**
AMT:	Regular Taxable Income	$ 74,200	$279,520
	Personal Exemptions	6,800	4,352
	Taxes	9,000	9,000
	Itemized Deduction Phaseout	0	(2,872)
	AMTI	90,000	290,000
	AMT Exemption	(66,250)	(31,250)[5]
	AMTI after Exemption	$ 23,750	$ 258,750
	Tentative Minimum Tax	**$ 6,175**	**$ 45,275**
	Regular Tax	$ 11,404	42,729
	AMT	0	2,546
	Total Tax	**$ 11,404**	**$ 45,275**

The addition of $200,000 of long term capital gain resulted in $2,546 of AMT even though we are told that the long term capital gain rate is 15% for both regular tax and AMT. Remember that the exemption phases out at 25 cents on the dollar. Therefore, while AMTI is in the exemption phaseout range, long term capital gain is taxed at 15% ***plus*** 25% of 28% (or 26%) for a maximum of 22%.

[4] Consists of $9,000 in taxes, and $10,000 mortgage interest.

[5] ($290,000 AMTI - $150,000 floor) * 25%=$35,000 disallowed. $66,250 maximum credit - $35,000 disallowed=$31,250 exemption.

Capital Gains Rate Review

Before determining at what rates capital gains are taxed for AMT purposes, the regular tax rules should be reviewed. For regular tax purposes, only "adjusted net capital gain" is eligible for the 15%/5% (0% in 2008) rate.

Adjusted net capital gain means the net capital gain reduced (but not below zero) by the sum of:

1. Unrecaptured § 1250 gain, and

2. Any gain subject to the 28% rate.

   Gain subject to the 28% rate is the excess of the sum of:
   a. Collectibles gain, and
   b. § 1202 gain, over
   The sum of:
   a. Collectibles losses,
   b. The net short-term capital loss, and
   c. The amount of long term capital loss carried under § 1212(b)(1)(B) to the taxable year.

To the extent that a taxpayer has unused 15% (or 10%) bracket, adjusted net capital gains is taxed at 5% (goes to 0% in 2008).

Capital Gain Rates in AMT

The same scheme applies to AMT. To the extent that a taxpayer has unused 15% (or 10%) bracket for regular tax purposes, any capital gain eligible for a 15% rate in AMT will also be taxed at 5% for AMT purposes (0% in 2008).

Example

In 2007, when the top of the 15% bracket is $63,700 Dennis and Roberta have the following income items:

	Regular Tax	AMT
Wages	$27,000	$27,000
Unrecaptured Sec. 1250 Depreciation	30,000	30,000
Long Term Capital Gain	35,000	35,000
Less Standard Deduction	(10,700)	0
Less Exemption	(6,800)	(66,250)
Taxable Income	74,500	$ 25,750
Their unused 15% (or 10%) Bracket is $21,200 as Follows		
Taxable Income	$74,500	$25,750
Adjusted Net Capital Gain ($65,000-$30,000)	(35,000)	(35,000)
Taxable Income Less Adjusted Net Capital Gain	39,500	0
Top of15% Bracket	$63,700	$63,700
Less Used 15% Bracket	(39,500)	(39,500)
Unused 15% Bracket	$24,200	$ 24,200
Composition of total tax:		
Regular Tax:	**Income**	**Tax**
Regular 10% Bracket	$15,600	$ 1,560
Regular 15% Bracket	23,900	3,585
Capital Gains Taxed at 5% (Unused 15% Bracket)	**24,200**	**1,210**
Remaining Capital Gain Taxed at 15%	10,800	1,620
Total	$74,500	$ 7,975
Alternative Minimum Tax	**Income**	**Tax**
Capital Gains Taxed at 5% (Unused 15% Bracket)	**24,200**	**1,210**
Remaining Capital Gain Taxed at 15%	1,550	233
Total	$25,750	$ 1,443

Planning: Because it is the **regular tax unused 15% bracket** that determines how much long term capital gain will be taxed at 5% (0% in 2008) in AMT, **paying additional taxes may reduce AMT** if such payment increases the unused 15% bracket.

The Working Families Tax Act of 2004 Changes the Calculation

The Working Families Tax Act of 2004 makes changes to § 55(b)(3)(B) that lowers AMT for some taxpayers. The change is effective as if included in the provision of the Taxpayer Relief Act of 1997. Prior to this change the amount of 15% net capital gain that could be reduced to 5% in AMT was limited to the amount that was reduced for regular tax purposes. This Calculation applied even if a taxpayer's regular taxable income was below the top of the 15% bracket (e.g. $63,700 for married joint in 2007).

Pursuant to the revised calculation the amount of 15% net capital gain that can be reduced to 5% in AMT is the excess the top of the 15% bracket less taxable income reduced by adjusted net capital gains. In other words, the AMT amount may be larger than the regular tax amount.

C. Foreign Tax Credit

The foreign tax credit may be used to reduce tentative minimum tax. The alternative minimum tax foreign tax credit (AMTFTC) is the foreign tax credit recalculated by applying the AMT rules to income and deductions.

Beginning in 1998, taxpayers whose foreign tax credit did not exceed $300 ($600 if married filing jointly) and who met certain other requirements, are not required to complete Form 1116 (Foreign Tax Credit) in order to claim the credit for regular tax purposes. However, a taxpayer claiming an AMTFTC must complete Form 1116 for regular tax for purposes of figuring the AMTFTC.

For tax years after 1997, taxpayers may elect to use regular taxable income for purposes of computing the § 904 limitation for AMT purposes and avoid recomputing the limitation based on AMT amounts. The election must be made for the first tax year after 1997 in which the taxpayer has a foreign tax credit. Otherwise the § 904 limitation must be recomputed using income and deductions allowed for AMT that are attributable to sources outside the United States.

The AMTFTC is limited to (with some exceptions when ATNOLDs or IDCs exist) 90% of tentative minimum tax before the credit for tax years beginning December 31, 2004 or earlier. **The American Jobs Creation Act of 2004** repeals the 90% limitation for tax years beginning after December 31, 2004.

> **Worksheet:** The Foreign Earned Income Tax Worksheet in the instructions to Form 6251 has been revised to reflect changes made by the Tax Technical Corrections Act of 2007.

D. Compare Tentative Minimum Tax To Regular Tax

The excess of tentative minimum tax over regular tax (reduced by the regular tax foreign tax credit and tax on lump sum distributions) is the **ALTERNATIVE MINIMUM TAX!**

IV. SPECIAL SITUATIONS

A. Kiddie AMT

Even children under 18 years old (even older for 2008) may be subject to AMT. Generally, net unearned income of a child under 18 years old is subject to tax at his or her parents' higher rate.

> **More Kids in Kiddie Tax:** The Tax Increase Prevention and Reconciliation Act of 2006 raises the age at which children are subject to the Kiddie Tax from under 14 to under 18, retroactively for all of 2006. For 2008 **The Small Business and Work Opportunity Tax Act of 2007** generally applies Kiddie Tax to any child who is a full-time student

over the age of 18, but under 24 at the end of the year unless the child's earned income exceeds 50% of total support.

Beginning in 1998, TRA 1997 increased the AMT exemption amount for a child under age 18 (was 14 prior to 2006) to the lesser of (1) the exemption amount for a single taxpayer or (2) the sum of the child's earned income plus $5,000 indexed for inflation ($6,300 in 2007 and $6,400 in 2008).

B. Farmers And Fishermen Who Income Average

Special income averaging methods are available to farmers and fishermen who elect them. The American Jobs Creation Act of 2004 provides that AMT rules will ignore reduction in tax due to income averaging for regular tax purposes when computing AMT. Thus, the benefit of income averaging will not be diminished by AMT.

C. Interaction Of Credits And Amt

Non Refundable Personal Tax Credits

Generally, non refundable personal tax credits (the dependent care credit, the credit for the elderly and disabled, the adoption credit, the child tax credit, the credit for interest on certain home mortgages, the Hope and Lifetime Learning Credits and the DC homebuyer's credit) have been allowed only to the extent that an individual's regular income tax liability exceeded the individual's tentative minimum tax, determined without regard to the minimum tax foreign tax credit. In other words, taxpayers subject to AMT received no benefit from non refundable personal tax credits and taxpayers whose AMT approached their regular tax received only a reduced benefit from these credits.

For 1998 and 1999, Congress enacted some temporary relief from this problem by treating AMT as zero for purposes of calculating non refundable personal tax credits. For 2000 and 2001, further temporary relief got better when Congress provided that individuals may offset both regular tax and AMT with non refundable personal tax credits (*"Ticket to Work" Act of 1999; Tax and Trade Relief Extension Act of 1998;* § 26). The 2001 Act made permanent some of these provisions for tax years beginning after December 31, 2001.

The impetus for the change was presumably the "child credit" passed in TRA 1997, a non refundable personal tax credit. This credit was advertised as a credit to reduce the tax of middle and low income taxpayers; therefore the fact that the regular tax could only be reduced to the level of the AMT became a large problem for Congress as many of these taxpayers with several children could not fully utilize the credit due to this provision. Congress was forced to enact more laws to mitigate this effect so as not to have egg on their collective faces.

For tax years beginning after 2001, the following credits are allowed against a taxpayer's regular tax and AMT until EGTRRA sunsets for year beginning after December 31, 2010.

- Child Tax Credit (§ 24(b)),
- Adoption Credit (§ 23(b)(4)), and
- Elective Deferral and IRA Contribution Credit (§ 25B(g)[h]).

For 2005-2005, the Job Creation Act (2002) and the Working Families Tax Relief Act (2004) provides that <u>all personal nonrefundable credits</u> are allowed against an individual's regular tax and AMT.

For 2006 only the Tax Reconciliation Act of 2006 extends the provision allowing taxpayers to use all nonrefundable personal credits to offset AMT.

For 2007 only the Tax Increase Prevention Act of 2007 allows an individual to offset the entire regular tax liability and alternative minimum tax liability by the nonrefundable personal credits.

> **Energy Credits:** The new credits for certain nonbusiness energy property (§ 25C) and residential energy efficient property (§ 25D) may be used to offset AMT. However, the alternative motor vehicle credit (§ 30B) and the credit for alternative fuel refueling property (§ 30C) **do not** offset AMT.

Business Credits

The American Jobs Creation Act of 2004 provides that the following energy credits can be used to offset both the regular tax and the AMT:

- Alcohol fuels credit for tax years beginning after December 31, 2004, and
- The credit for electricity or refined coal produced at a facility placed in service after October 22, 2004, during the first four years of production beginning on the date the facility was originally placed in service.

The Small Business and Work Opportunity Tax Act of 2007 provides that the following credits offset AMT for tax years beginning after December 31, 2006:

- FICA tip credit – taxes paid with respect to employee cash tips, and
- WOTC – work opportunity tax credit.

Earned Income Credit

For tax years beginning after December 31, 2001, the earned income credit is no longer reduced by the amount of an individual's AMT (§ 32(h) as removed by the 2001 Act).

V. MINIMUM TAX CREDIT

Some AMT adjustments reflect a difference in tax treatment between regular tax and AMT. For example, deductions for most taxes are allowed for regular tax purposes but not for AMT. Other AMT adjustments reflect only a timing difference as to when an item is deductible or includible in income for regular tax versus AMT. Examples of timing differences are depreciation deductions and the exercise of ISOs.

The same income item may be subject to AMT in one year and regular tax in another. The minimum tax credit prevents this double tax. When a taxpayer pays AMT due to a timing difference, the AMT generally is allowed as a credit against the regular tax liability of the taxpayer in subsequent years. However, **prior to 2007** the AMT credit could not be used to reduce AMT in subsequent years. In other words, the AMT credit was carried forward and used to reduce regular tax down to, but not below, AMT in subsequent years. See below for the relief provisions beginning in 2007.

The minimum tax credit is allowed only with respect to AMT arising as a result of deferral adjustments and preferences (i.e., adjustments and preferences other than those that result in permanent exclusion of certain income for regular tax purposes). Thus, the amount of AMT credit is reduced by the exclusion items. Exclusion items are AMT adjustments and preferences for:

- The standard deduction
- Itemized deductions
- Certain tax-exempt interest
- Depletion, and
- Excluded gain from disposition of qualified small business stock.

The AMT credit can be carried forward indefinitely. Thus, it is not necessary for the taxpayer to determine which prior year's AMT credit is being used in a particular year. The AMT credit cannot be carried back.

Example

For 2006, Mel's AMT is:

Tentative Minimum Tax	$45,000
Regular Tax	(30,000)
AMT	$15,000

If tentative minimum tax were calculated taking into account only exclusion items, Mel's AMT would be $6,000. Therefore, his credit is limited to $9,000 as follows:

AMT	$15,000
AMT Due to Exclusion Items	(6,000)
AMT Credit	$ 9,000)

In 2007, Mel's regular tax is $35,000 and his tentative minimum tax is $30,000. Therefore, he may use only $5,000 of the AMT credit carryover. The $4,000 remaining AMT credit will carry forward to future years.

A. AMT Credit Relief Begins In 2007

The Tax Relief and Health Care Act of 2006, signed into law on December 20, 2006, provides some relief to taxpayers with older AMT credits. For individuals who have "long-term" AMT credits (over three years old), a portion of the credit carryover qualifies as an **AMT refundable credit.** The term "AMT refundable credit" amount is the greater of:

1. $5,000 (limited to the amount of long-term credit),
2. 20% of the long-term credit, or
3. The amount, if any, of the AMT refundable credit amount determined for the taxpayer's preceding taxable year (before any reduction due to adjusted gross income) (§ 53(e)(2)(A)).

Phaseout: If adjusted gross income exceeds the thresholds at which exemptions are subject to phaseout, the amount of credit available is reduced 2% for every $2,500 in excess of the threshold. For 2007, the AGI thresholds are $156,400 for single taxpayers and $234,600 for married taxpayers.

Long-term Credit Not in Addition to Regular Minimum Credit: The total amount of AMT credit carryover that may be used is the greater of the excess of regular tax over AMT (old provision) or the new AMT refundable credit. The regular AMT credit is not refundable, however, the portion arising from this new provision is refundable.

Declining Balance No Longer Applies: The law as originally enacted provided that the balance of long-term credits available for this provision be recalculated each year. **The Technical Corrections Act of 2007** modified the calculation by adding item 3 above. The impact is that with the technical correction a taxpayer may use all of his or her long-term credit in five years.

Effective Date: This relief provision is effective for tax years beginning after December 20, 2006 and before January 1, 2013.

> **Planning:** Lower income translates to more likely use of the credit. Postponing, shifting and/or bunching income may maximize the new AMT refundable credit.

Example

A.M. Tee is single and has an AMT credit carryover into 2007 of $200,000. $180,000 of the credit was from 2003 or prior years (the "long-term" portion). If A.M.'s adjusted gross income for 2007 is $156,400 or less, he is able to use $36,000. In fact, if withholding exactly covered tax on A.M.'s income, he will receive a refund check of $36,000.

Phase Out: If A.M. Tee's AGI increases to $256,400, he will be able to use only $7,200 ($36,000 – 80% (($256,400-$156,400)/$2,500 multiplied by 2% = 80%) of $36,000).

Regular and long-term unused minimum tax credits: If A.M. Tee's regular tax liability for 2007 is $34,000 and his AMT liability is $30,000, A.M. Tee is able to use $4,000 of his regular AMT credit. His total credit of $36,000 (assuming AGI under $156,400) consists of $4,000 regular (and non refundable) AMT credit plus $32,000 new long-term (and refundable) AMT credit.

B. Increasing The AMT Credit

Increasing the AMT credit reduces total tax between years when:

1. The taxpayer will have an opportunity to use the credit in the near future and the regular tax rate in the year that the credit is used is lower than in the year that the credit was created.

2. The taxpayer will be in AMT in the following year due only to exclusion items. Assuming that the tax must be paid in year one or year two, payment in year one yields a credit (potential tax savings): whereas, payment in year two produces no current or future tax benefit.

How to Increase the AMT Credit

The AMT credit is only available to the extent that AMT due to deferral items exceeds regular tax. If all AMT due to deferral items does not exceed regular tax, the AMT credit will be limited to the difference. The maximum AMT credit will result when regular tax is reduced to AMT calculated without deferral items.

- ❑ This can be accomplished by acceleration of tax payments or miscellaneous itemized deductions which are exclusion items, reducing regular tax but not AMT. In this strategy, a bigger credit is created at the sacrifice of a future deduction.

- ❑ The payment of other itemized deductions, deductible for both regular tax and AMT, such as certain interest or charitable contributions, may also do the trick by reducing regular tax more rapidly (due to presumably higher regular tax rates) than AMT.

If the excess of AMT over regular tax is due both to deferral and exclusion items, the credit may be optimized by:

- o Postponing payment of exclusion items to increase regular tax to the extent that the entire amount of AMT results in an AMT credit. If exclusion items are not postponed in this situation, they will be wasted, creating no tax reduction now and no credit for later.

- o Accelerating income that is taxable for both regular tax and AMT purposes. This will eventually increase regular tax (going up at a higher rate) to the point where all AMT results in a credit.

VI. LIKELY VICTIMS OF AMT – EVERYONE

Knowing who may fall prey to AMT is not as easy as it once was. Certainly, high income taxpayers find AMT much more troublesome than most. In addition to a high income, the following factors seem to aggravate (or cause) AMT.

Capital Gains – Taxpayers with large capital gains will find that even though the rates on capital gains for regular tax and AMT are the same, large capital gains can result in AMT due to the AMT exemption phaseout.

Suspended Passive Losses – Differences in accumulated suspended passive losses for regular tax and AMT will also result in AMT.

Incentive Stock Options – Taxpayers with incentive stock options (ISOs) who embark upon a strategy to exercise and hold, will frequently find themselves subject to AMT. While the exercise of an ISO does not trigger income recognition for regular tax purposes, the "bargain" (spread between cost and FMV) is recognized for AMT purposes.

Large Miscellaneous Itemized Deductions – Employees in sales and other occupations requiring large outlays for business may reap no tax advantage for their "unreimbursed business expenses" which fall into the miscellaneous itemized deduction category and are not deductible in calculating AMTI. The same holds true for substantial investment expenses.

High State Income Taxes – Taxes are not deductible in calculating AMTI. Taxpayers who experience an unusual spurt of income may find themselves in AMT if they pay the state tax on the extraordinary income in the subsequent year when their income has returned to normal.

Big Families – Most would argue that a child is not a tax shelter. Yet, a large deduction for personal exemptions can push taxpayers into AMT.

Example

Sharon and Bill have 8 children. In 2007, they fell prey to AMT as follows (see ***Klaasen,*** **TC Memo 1998-241):**

	Regular Tax	**AMT**
Adjusted Gross Income	$150,000	$150,000
Less Standard Deduction	(10,700)	0
Exemptions	(34,000)	(66,250)
Taxable Income	$105,300	$ 83,750
Regular Tax/Tentative Minimum Tax	$ 19,173	$ 21,175
AMT	$ 2,602	

VII. PREPARATION PITFALLS

The calculation of AMT is a challenge for even the most experienced tax preparer. Often the adjustments are not obvious, nor are they automatically generated by the computer. A few things to watch when calculating AMT are:

- ✓ The basis of assets that are disposed of must be adjusted to reflect AMT differences.

- ✓ Passive loss adjustments are confusing. For example, assume that Will receives a Schedule K-1 from a limited partnership that includes a loss of $4,500 and a positive AMT adjustment of $1,000. This means that the loss for AMT purposes is $3,500. However, if Will is unable to deduct the loss of $4,500 for regular tax purposes due to the passive loss rules, he should not add the $1,000 AMT adjustment on his Form 6251.

- ✓ One of the most common AMT adjustments accounts for differences between regular tax and AMT depreciation. Generally, computer software automatically handles these adjustments. However, the software is only as accurate as the information it receives.

VIII. AMT PLANNING

Planning for the taxpayer in AMT is possible, not easy, but possible! The uniqueness of each situation, with the multitude of variables involved, makes the best type of planning taxpayer specific planning. There is no substitute for taking the taxpayer's "as is" set of facts and exploring "what ifs", hopefully with the help of tax planning software.

A. Variables

Planning usually means accelerating or postponing income or deductions in order to minimize the tax burden over several years. ***Variables*** to consider in AMT planning include:

- ✓ Relative regular tax and AMT top marginal tax rates. Remember that the AMT rate can be as high as 35% due to the phaseout of the AMT exemption.

- ✓ Likelihood that the taxpayer will be in AMT next year and the year after that? The answer to this question determines when a taxpayer will be able to use an AMT credit carryover.

- ✓ Adjusted gross income for 2007 through 2012. Will the taxpayer be able to use long-term AMT credit carryovers?

- ✓ Reason that the taxpayer is in AMT. The taxpayer may be in AMT due to deferral items, exclusion items, or a combination of these.

- ✓ Ability to move income and/or deductions between years. The ability to plan is greatly enhanced by the control over income and deductions.

The planning process starts with ascertaining the taxpayer's "as is" position, what the taxpayer has already done and what must be done in the remainder of the year. Next, potential alternative actions should be explored, including what the taxpayer could do and what he or she would like to do.

> **Caution:** Not only tax, but economic factors and the taxpayer's outlook must influence any planning. This discussion relates only to tax planning.

B. "What If" Planning

Sample Planning for Dennis and Roberta, whose 2007 facts are:

Wages	$160,000
2006 state income tax paid in 2007	5,000
Real estate tax	4,000
State income tax withholdings	9,000
Mortgage interest	10,000
ISO bargain element	40,000

Regular tax and AMT for Dennis and Roberta in their "as is" position are:

	Regular	**AMT**
Wages $160,000	$160,000	$160,000
AMT Adjustment (ISO)	0	40,000
Itemized Deductions	(28,000)	(10,000)
Phaseout	72	
Exemptions	(6,800)	(66,250)
Phaseout	0	10,000
Taxable Income	$125,272	$133,750
TAX	$ 24,166	$ 34,775
AMT	**$ 10,609**	

<u>Accelerating Income in an AMT Year</u>

"What if" Roberta takes a $10,000 bonus this year?

	Regular	**AMT**
"What if" Tax	$26,925	$38,025
"As is" Tax	(24,116)	(34,775)
Difference	$ 2,809	$ 3,250
Effective Rate	28.1%	32.5%

Dennis and Roberta, still in AMT with the $10,000 bonus, will pay 32.5% in tax on the bonus. 2007 may be a very good year to take the bonus if they anticipate that they will be subject to regular tax next year at a rate higher than 32.5%.

"What if" Roberta takes a $100,000 bonus this year?

	Regular	AMT
"What if" Tax	$54,529	$68,950
"As is" Tax	(24,166)	(34,775)
Difference	$30,363	$34,175
Effective Rate	30.4%	34.2%

Dennis and Roberta are still subject to AMT with a $100,000 bonus. Their AMT rate has increased to 32.2% (a combination of the 26% and 28% rates impacted by the phaseout of the exemption). Notice that the effective rate for regular tax increased more than the effective rate for AMT. If enough ordinary income is added, eventually the regular tax rate will be 35% and the AMT rate will drop back to 28%.

Accelerate Deductions, Deductible For Both Regular Tax and AMT

"What if" Dennis and Roberta make a $10,000 charitable contribution this year?

	Regular	AMT
"What if" Tax	$21,666	$31,525
"As is" Tax	(24,166)	(34,775)
Difference	$ 2,500	$(3,250)
Effective Rate	25.0%	32.5%

The contribution of $10,000 reduces tax by $3,250 or 32.5%. Note that this is actually more of a tax benefit due to AMT as Roberta and Dennis's regular tax rate is 25%.

Take 15% Capital Gains

"What if" Dennis sells some stock with a long term capital gain of $100,000?

	Regular	AMT
"What if" Tax	$39,915	$56,275
"As is" Tax	(24,166)	(34,775)
Difference	$15,749	$21,500
Effective Rate	15.7%	21.5%

Despite the fact that the 15% applies to capital gains in both regular tax and AMT, the **effective rate** is higher than 15% in both. Because the exemption in AMT phases out at such a dramatic pace (25% of each $1 of additional income), the effective rate on capital gains tends to be higher in an AMT year for the range of income in which the phaseout occurs.