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Alternative Minimum Tax*

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Introduction

Congress imposes the alternative minimum tax (AMT) on taxpayers to prevent them from combining several tax exclusions, deductions and credits to pay very little or no federal income tax even though they have significant income. When it was first enacted in 1969, the AMT affected only a few, very high-income taxpayers. Since it was first imposed, changes to the regular tax rules cause many more taxpayers to pay the AMT. This fact sheet gives a basic explanation of the AMT, some examples of situations that cause taxpayers to pay it, and some planning techniques to minimize the impact of the AMT.

The terminology of the AMT tax can be confusing, because the tax that Congress calls the AMT is technically an add-on tax rather than an alternative to the regular income tax—the AMT is added on to the regular tax liability. The IRS follows the Congressional labeling and calls the amount of tax added on to the regular tax the "alternative minimum tax." Therefore, taxpayers report their regular income tax on their income tax return and then add on the AMT to find their total income tax liability.

While the AMT is technically an add-on tax, it has the effect of an alternative tax because taxpayers calculate their AMT by subtracting regular tax liability from a "tentative minimum tax." If the tentative minimum tax is less than the regular tax, there is no AMT. If the tentative minimum tax is greater than the regular tax, the AMT is the difference between the tentative minimum tax and the regular tax. Because the AMT is added to the regular tax, the effect of these rules is that taxpayers pay the higher of the regular tax or the tentative minimum tax. Therefore, the tentative minimum tax is in effect an alternative tax that taxpayers must pay if it exceeds their regular tax obligation.

This fact sheet focuses on the AMT imposed on individual taxpayers. Because only the owners of partnerships, S corporations, and limited liability companies (LLCs) that are taxed as

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disregarded entities, partnerships, or S corporations are taxed on the income of those entities (the entities do not pay tax on the income), the individual AMT is the only AMT imposed on the income of those entities. The AMT imposed on C corporations is discussed briefly at the end of the fact sheet.

Basic AMT Calculation

Taxpayers compute their tentative minimum tax by first computing their alternative minimum taxable income (AMTI), which is their taxable income for regular tax purposes adjusted by the difference between deductions that are allowed for the regular tax and those that are allowed for the AMT. The AMTI is then reduced by an exemption amount and the result is multiplied by 26% for the first $175,000 ($87,500 for married filing separately) and 28% for the amount over $175,000 ($87,500) to find the tentative minimum tax.

AMT Adjustments

To calculate AMTI, taxpayers start with their taxable income and then add back some of the deductions they claimed to compute their taxable income. They also make some adjustments that reduce their taxable income. These adjustments account for the differences between the deductions that are allowed for the regular income tax and those that are allowed for the AMT.

Example 1: Andy and Mary Thompson are married and have 4 children. To calculate their $65,000 of taxable income for 2011, they included the following deductions.

$28,876 of depreciation on a farm building that was built in 2010 for $400,000 and is depreciated over 20 years using the 150% declining balance method

$5,000 of state income tax

$10,000 of real property taxes on their home

$22,200 personal and dependent exemptions deduction for Andy, Mary and their 2 children

The AMT rules require Andy and Mary to add the following to their taxable income to compute their AMTI.

1. The $8,876 of depreciation deducted for the farm building that exceeds the $20,000 of depreciation that could be claimed using the straight-line depreciation method over 20 years.
2. The $5,000 of state income taxes
3. The $10,000 of real property taxes on their home
4. The $22,200 personal and dependent exemptions deduction

Andy and Mary must add the $46,076 total of these adjustments to their $65,000 taxable income to compute their $111,076 AMTI.

AMT Exemption Amounts

Taxpayers reduce the AMTI by an exemption amount and multiply the result by the 26% (for the first $175,000) and 28% (for any amount over $175,000) AMT rates. Figure 1 shows the AMT exemption amounts provided in Internal Revenue Code Section 55(d)(1). However, Congress has temporarily increased these exemption amounts for taxpayers filing an individual return each year beginning in 2001, and it is likely to continue to increase them each year or otherwise change the AMT rules to reduce the impact of the exemption amounts provided in Internal Revenue Code Section 55(d)(1). To illustrate the temporary increases, Figure 1 also shows the exemption amounts that are in effect for 2011. The examples in this fact sheet use the rates shown in Figure 1 for 2011. If Congress does not temporarily increase the AMT exemptions for a year after 2011, the AMT liability will be dramatically increased for that year for some taxpayers.

Figure 1. AMT Exemption Amounts

Filing Status		I.R.C. § 55(d)(1) Exemption Amount		2011 Exemption Amount
Married individuals filing jointly	$	45,000	$	74,450
Surviving spouses		45,000		74,450
Single individuals		33,750		48,450
Married individuals filing separately		22,500		36,225
Estates and trusts		22,500		22,500
Corporations		40,000		40,000

Example 2: Andy and Mary Thompson from the previous example compute their AMT as shown below.

AMTI	$111,076
Exemption	- 74,450
AMT tax base	$ 36,626
AMT tax rate on first $175,000 of AMTI	0.26
Tentative minimum tax	$ 9,523
Regular tax on $65,000	- 8,904
AMT	$ 619

Note that Andy and Mary pay the $8,904 regular tax plus the $619 AMT for a total tax of $9,523, which is equal to the tentative minimum tax. Therefore, the effect of the AMT is to make Andy and Mary pay the higher of their regular tax liability or their tentative minimum tax.

Note. If Congress had not increased the AMT exemptions for 2011, Andy and Mary will owe $8,276 of AMT for 2011. Subtracting the $45,000 exemption from their $111,076 AMTI leaves $66,076. When $66,076 is multiplied by the 26% AMT rate, the tentative minimum tax is $17,180, which exceeds their $8,904 regular tax by $8,276.

Adjustments that Create an AMT Credit

The AMT adjustments that just defer deductions rather than permanently prohibiting a deduction are the adjustments that can create an AMT credit. For example, some assets can be depreciated at a faster rate for regular tax purposes than for AMT purposes. In the early years of depreciating those assets, the regular tax depreciation exceeds the AMT depreciation and the excess is a positive adjustment to AMTI that can cause an AMT liability. In the later years of depreciating those assets, the regular tax depreciation is less than the AMT depreciation and the deficit is a negative adjustment to AMTI. By the end of the recovery period for those assets, the total regular tax depreciation and AMT depreciation are the same. Therefore, the AMT rules simply deferred the depreciation deduction—they did not reduce the total depreciation deduction.

The most common AMT adjustments that **do not** create an AMT credit because they cause a permanent difference in regular taxable income and AMTI (i.e. they are **not** deferral items) are:

- Itemized deductions, including any investment interest expense reported on Schedule E
- The standard deduction
- Personal and dependent exemptions deduction

Example 3: In the previous example, Andy and Mary Thompson's AMT for 2011 was $619. Three of their four AMT adjustments--$5,000 of state income tax, $10,000 of real property taxes, and $22,200 of personal and dependent exemptions deduction—are **not** deferral adjustments (they are permanent adjustments) and the AMT caused by those adjustments do not create an AMT credit. However, their $8,876 depreciation adjustment is a deferral adjustment that creates a $619 AMT credit (without the $8,876 depreciation adjustment, the 2011 AMT would have been zero). That credit can by subtracted from their regular tax liability in 2012, but it can reduce their regular tax liability only down to their tentative minimum tax for 2012. Any excess can be carried forward to reduce regular income taxes in future years subject to the same limit.

Note. Because Andy and Mary get a $619 credit in 2012 for the AMT they paid in 2011, the AMT has not increased their income tax, it has only accelerated it from 2012 to 2011.

AMT Management and Planning Issues

This section provides examples that show how the AMT affects taxpayers with large capital gains, itemized deductions that are limited for the AMT calculation, and high personal exemption deductions.

Taxpayers with Large Capital Gains

The AMT calculation allows taxpayers to use the same tax rate on capital gains as they use for regular tax liability. Although this provision appears to not trigger the AMT, taxpayers with large capital gains may be subject to AMT as a result of the loss of the AMT exemption. The tax on the capital gain does not change, but the tax on the ordinary income increases because the capital gains reduce the AMT exemption, which increases the ordinary income that is subject to the AMT rates.

Example 4: Tommy Hawk is single with no dependents. In 2011, Tommy decided to get out of farming so he sold his 70 acres of farm land but kept the home, outbuildings, and machinery. He had $25,000 of farm income for 2011 and $35,000 of wages from a new job. He sold the 70 acres of farmland for $260,000. His income tax basis in the land was $30,000, so he had a $230,000 capital gain from the sale of the land.

Tommy elected the $5,800 standard deduction, and his personal exemption deduction is $3,700. If Tommy had not sold the farm land in 2011, he would not owe any AMT because he could subtract his $48,450 AMT exemption from his $58,234 ($25,000 farm income – $1,766 SE tax deduction + $35,000 wages) AMTI and the $2,544 tentative minimum tax on the remaining $9,784 ($9,784 × 26% = $2,544) is less than the $8,769 regular tax on his $50,500 taxable income.

The capital gains from the sale of the farm land increase his AMTI to $288,234 and cause his $48,450 AMT exemption to be reduced to $4,517. The calculation of his $278,734 taxable income is below.

Farm income	$ 25,000
Less: Deduction for 50% of SE Tax	– 1,766
Wages	35,000
Long-term capital gain	230,000
($260,000 sale – $30,000 basis)	
Adjusted gross income (line 38 Form 1040)	$288,234
Less: Standard deduction	- 5,800
Less: Personal exemption deduction	- 3,700
Taxable income	$278,734

Example 4 cont'd:

Tommy's regular income tax on his $278,734 of taxable income is $42,815 because the maximum tax rate for his capital gains is 15%. His $5,652 AMT calculation is shown below.

Taxable income	$278,734
Standard deduction	+ 5,800
Personal exemption deduction	+ 3,700
AMTI	$288,234
Exemption*	- 4,517
Tentative minimum tax base	$285,925
Tentative minimum tax**	$ 48,467
Regular tax	- 42,815
AMT	$ 5,652

* Tommy's AMT exemption is $4,517 because his $288,234 AMTI causes his exemption amount to be reduced by $43,934 ($48,450 – $43,934 = $4,517).

** Tommy's tentative minimum tax is $48,467 (26% of the $53,718 by which his $58,234 ordinary income exceeds his $4,517 AMT exemption) plus $34,500 (15% of his $230,000 capital gain).

Planning Pointer

If capital gains cause you to pay the AMT, spreading them over more than one year can reduce or eliminate the AMT. Spreading the capital gains can keep your AMTI below the threshold for reducing the AMT exemption amount and therefore allow the exemption to offset the regular income.

The current income tax rates on long-term capital gains are as low as they have been for many years and will increase in 2013 under current law. The risk of paying higher income tax on long-term capital gains in future years should be factored in to a decision to postpone capital gains.

Capital gains can be spread over more than one year by making an installment sale or by selling part of the assets in each of two or more years. Be sure to compare the tax savings with the risk of not getting paid on an installment contract or the risk of a price decrease if you delay selling part of the assets.

Example 5: Tommy Hawk from the previous examples sold his farm land for $260,000, but instead of getting one payment he entered into an installment contract that requires the buyer to pay $130,000 down in 2011 and a $130,000 payment plus interest in 2012. After subtracting $15,000 of basis from each of those payments, Tommy has $115,000 of long-term capital gain to report in 2011 and 2012. He had $58,234 of ordinary income each year and claims the standard deduction and one personal exemption deduction. Tommy's AMT for 2011 is zero as shown below.

Taxable income ($58,234 + $115,000)	$163,734
Standard deduction	+ 5,800
Personal exemption deduction	+ 3,700
AMTI	$173,234
Exemption*	- 33,266
Tentative minimum tax base	$139,968
Tentative minimum tax**	$ 23,742
Regular tax	- 25,565
AMT	$ 0

* Tommy's AMT exemption is $33,266 because his $173,234 AMTI causes his AMT exemption amount to be reduced by $15,184 ($48,450 - $15,184 = $33,266).

** Tommy's tentative minimum tax is $23,742 (26% of the $24,968 by which his $58,234 ordinary income exceeds his $33,266 AMT exemption) plus $17,250 (15% of his $115,000 capital gain).

If the AMT exemption amounts, tax rates, standard deduction and personal exemption deduction are the same for 2012 as they are for 2011, Tommy will owe no AMT for 2011. Spreading the capital gain over the two years reduces his total AMT for the two years from $5,652 to zero.

Itemized Deduction Limitations for AMT Calculation

The AMT calculation limits the Schedule A (Form 1040) itemized deductions. Four of the more common itemized deductions subject to AMT limitations are:

1. State and local taxes, including property taxes, income taxes, and sales taxes. These are not deductible in calculating AMT. Taxpayers with high state and local taxes are more likely to have an AMT liability.
2. Miscellaneous itemized deductions subject to the 2% of AGI floor:
    - Taxpayers' hobby activity deductions are allowed as a 2% of AGI floor miscellaneous deduction to the extent of the income from the hobby activity for regular tax purposes,

but they are not deductible for the AMT. Therefore, taxpayers with significant hobby expense deductions for regular tax purposes may have an AMT liability.

- Employee business expenses are allowed as a 2% of AGI floor miscellaneous deduction, but they are not deductible for AMT. Therefore, taxpayers with significant employee business expenses may have an AMT liability.

3. Home mortgage interest on indebtedness *not* used in acquiring, constructing, or substantially improving any property that is the taxpayer's main home or second home that is a qualified dwelling. It is not deductible for AMT.
4. Medical and dental expense deductions. For the AMT calculation, they are limited to a 10% of AGI floor instead of the 7.5% of AGI floor that applies to the regular tax liability calculation.

Example 6: Dana Miller, a single taxpayer with no dependents, has $45,000 of wages for 2011. She raises horses and the IRS treats her horse activities as a hobby because she has not made a profit in the first seven years of raising horses. In 2011, Dana had $40,000 of revenue and $45,000 of expenses from her horse activity. The hobby loss rules limit her deduction of the expenses for regular tax purposes to her $40,000 of revenue. The deduction is further reduced by 2% of her adjusted gross income. The calculation of her taxable income and regular tax liability for 2011 is shown below.

Wages			$ 45,000
Revenue from horse activity			40,000
Adjusted gross income			$ 85,000
Itemized deductions			
State income taxes		1,500	
Real property taxes		2,500	
Home mortgage interest		10,000	
Charitable contributions		2,000	
Miscellaneous deductions			
Horse activity expenses*	40,000		
2% of adjusted gross income	1,700		
Excess over 2% of AGI		38,300	
Total Itemized deductions			- 54,300
Personal exemption deduction			- 3,700
Taxable income			$ 27,000
Regular income tax			$ 3,629

* The $45,000 of expenses are deductible only to the extent of the $40,000 of revenue from the horse activity.

Example 6 cont'd:

The tax, miscellaneous itemized, and personal exemptions deductions are disallowed for the AMT calculation, resulting in a $1,604 AMT liability as shown below.

Taxable income	$27,000
State income taxes	1,500
Real property taxes	2,500
Miscellaneous deduction	38,300
Personal exemption deduction	3,700
AMTI	$72,950
AMT exemption	- 48,450
Tentative minimum tax base	$24,500
Tentative minimum tax ($24,500 × 26%)	$ 6,370
Regular tax	- 3,629
AMT	$ 2,741

Planning Pointer

Taxpayers who prepay property taxes or state income taxes for the following year (doubling the current year deduction) to maximize the use of the standard deduction the following year may find themselves with an AMT liability that reduces or eliminates the intended tax benefit.

AMT for Corporations

In general, the AMT for corporations is similar to the AMT for individuals. However, there are some important differences. The first important difference is that small C corporations are exempt from the AMT. For this purpose, a small corporation is one whose average annual gross receipts for all three-tax-year periods do not exceed $7,500,000. For the first three-tax-year period of the C corporation, the average annual gross receipts limit is $5,000,000. Therefore, most small and medium sized farms that are operated as a C corporation are not subject to the AMT.

For C corporations that are subject to the AMT there are some additional differences from the individual AMT. The AMT preferences and adjustments taken into account in computing AMTI are different. The AMT exemption is $40,000 for corporations. The tax rate used to compute the C corporations' tentative minimum tax is 20%. These differences affect the amount of AMT imposed on C corporations compared to the AMT imposed on individual taxpayers discussed earlier in this chapter.

The Future of the AMT

AMT has become a growing concern for more and more taxpayers. It affects more taxpayers because Congress has reduced regular income tax rates without changing the AMT rates. Regular tax rate brackets are also indexed for inflation, but the AMT brackets are not.

Congress has temporarily increased the AMT exemption amounts each year since 2001 and may temporarily increase them or make other changes to the AMT in future years. Congress has considered permanently increasing the AMT exemption amount and indexing it for inflation. Other potential solutions to the AMT problem are increasing the AMTI threshold for phasing out the AMT exemption and repealing the AMT.

Taxpayers should take these potential changes to the AMT into consideration when planning their business activities to minimize federal income taxes.

IRS Publications

For more detailed information about the AMT for individual taxpayers see the two-page Form 6251, Alternative Minimum Tax--Individuals, and the 12 pages of instructions for it. Form 6251 and its instructions can be accessed at www.irs.gov. Enter “Alternative Minimum Tax Form 6251” in the search box in the upper right hand corner.

Additional Topics

This fact sheet was written as part of Rural Tax Education a national effort including Cooperative Extension programs at participating land-grant universities to provide income tax education materials to farmers, ranchers, and other agricultural producers. For a list of universities involved, other fact sheets and additional information related to agricultural income tax please see RuralTax.org.