CHAPTER 9

ALTERNATIVE MINIMUM TAX

SYNPOSIS (click on section title to go directly there)

Introduction

Congress imposed the alternative minimum tax (AMT) to prevent taxpayers with significant income from combining specified tax exclusions, deductions, and credits so as to pay very little or no federal income tax. When it was first enacted in 1969, the AMT affected only a few very high-income taxpayers. But since it was first imposed, changes to the regular tax rules have caused many more taxpayers to pay the AMT. This chapter gives a basic explanation of the AMT, some examples of situations that cause taxpayers to pay it, and some planning techniques to minimize the AMT's impact.

Cross-Reference

More detailed information

For more detailed information about the AMT for individual taxpayers, see the 2-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 "Form 6251" in the search box in the upper right hand corner.

The terminology of the AMT tax is a little confusing because the tax is technically an add-on tax (added on to the regular tax liability) rather than an alternative to the regular income 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.

But 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 taxpayer's 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. The effect of these rules is that taxpayers must pay the higher of the regular tax or the tentative minimum tax.

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This chapter focuses on the AMT imposed on individual taxpayers. The individual AMT is the only AMT imposed on income from most partnerships, S corporations, and limited liability companies (LLCs) that are taxed as disregarded entities, because the income of those entities is taxed at the ownership (partner, shareholder, or member) level—the entities themselves do not pay tax on the income. The AMT imposed on C corporations is discussed briefly at the end of the chapter.

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. The resulting income 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.

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 9.1 AMT adjustments

Andy and Mary Thompson are married and have four children. In calculating their $65,000 taxable income for 2011, they included the following deductions that affect AMTI:

1. $28,876 depreciation on a farm building (built in 2010 for $400,000; depreciated over 20 years using the 150% declining balance method)
2. $5,000 state income tax
3. $10,000 real property taxes on their home
4. $22,200 personal and dependent exemptions deduction (Andy, Mary, and four children)

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

1. $8,876 of the farm building depreciation (this is the excess over the $20,000 of depreciation that could be claimed using the straight-line depreciation method over 20 years)
2. $5,000 state income tax (the entire amount)
3. $10,000 real property taxes on their home (the entire amount)
4. $22,200 personal and dependent exemptions deduction (the entire amount)

Adding the $46,076 total of these adjustments to their $65,000 taxable income results in an $111,076 AMTI.

AMT Exemption Amounts

Figure 9.1 shows the maximum AMT exemption amounts provided in the Internal Revenue Code (I.R.C.) for any year that the Congress does not temporarily increase them. However, each year beginning in 2001 Congress has temporarily increased these exemption amounts for individual returns, and it is likely to continue to increase them or otherwise change the AMT rules to reduce the impact of the AMT. Figure 9.1 also shows the temporary increase in the exemption amounts for 2011. The examples in this chapter use the amounts shown in Figure 9.1 for 2011. If Congress does not temporarily increase the AMT exemption amounts for a year after 2011, AMT liability will dramatically increase for some taxpayers.

Figure 9.1 AMT Exemption Amounts

Filing Status	I.R.C. Exemption Amount	2011 Exemption Amount
Married individuals filing jointly	$45,000	$74,450
Surviving spouses	45,000	74,450
Head of household	33,750	48,450
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 9.2 Basic AMT Calculation

Andy and Mary Thompson from Example 9.1 compute their AMT as shown in Figure 9.2.

FIGURE 9.2 AMT Calculation

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 taxpayers pay the higher of their regular tax liability or their tentative minimum tax.

✔ **Observation**

Exemption Amount Stated in I.R.C. Would Increase AMT

If Congress had not increased the AMT exemptions for 2011, Andy and Mary would 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.

AMT Credit

The AMT caused by some adjustments can create a credit that reduces regular income tax liability in subsequent tax years. In effect, these adjustments do not increase a taxpayer's total tax liability; they simply accelerate income tax liability by imposing the AMT in one year and reducing income taxes in a later year. Because taxpayers must pay the higher of their regular tax or their tentative minimum tax each year, a subsequent-year reduction of AMTI does not in itself produce the offsetting benefit that the credit provides.

Adjustments That Create an AMT Credit

The adjustments that can create an AMT credit are those that defer deductions rather than permanently prohibit them. 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 an addition 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 subtracted in calculating AMTI. By the end of the assets' recovery period, the total regular tax depreciation and the AMT depreciation are the same. Therefore, the AMT rules simply deferred the depreciation deduction—they did not reduce the total depreciation deduction.

AMT adjustments that cause a permanent difference in regular taxable income and AMTI **do not** create an AMT credit. These adjustments include

- itemized deductions, including any investment interest expense reported on Schedule E,
- the standard deduction, and
- the personal and dependent exemptions deduction.

Example 9.3 AMT Credit

In Example 9.2, Andy and Mary Thompson's AMT for 2011 was $619. Three of their four AMT adjustments—the $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. The AMT caused by those permanent adjustments does 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, their 2011 AMT would be zero). The credit can be subtracted from their regular tax liability in 2012, but a limit applies: It can reduce their regular tax liability only to their tentative minimum tax for 2012. Any excess is carried forward to reduce regular income taxes in future years, subject to each year's tentative minimum tax limit.

✔ **Observation**

AMT on Deferral Items Only Accelerates Tax Liability

Because Andy and Mary receive a $619 credit in 2012 for the $619 AMT they paid in 2011, the AMT did not permanently increase their income tax. The AMT only accelerated the $619 liability from 2012 to 2011.

AMT Management and Planning Issues

The examples in this section show how the AMT affects taxpayers with large capital gains or itemized deductions that are limited for the AMT calculation.

Taxpayers with Large Capital Gains

The same capital gains tax rates that are used for regular tax liability apply in calculating the AMT. Although these rates do not trigger the AMT, taxpayers with large capital gains nevertheless may be subject to the AMT as a result of a reduction or loss of the AMT exemption. The AMT exemption amounts shown in Figure 9.1are maximums; the exemption is phased out for higher income taxpayers. (The phase-out begins when AMTI exceeds $112,500 for taxpayers filing as single or head of household, $150,000 for joint returns and surviving spouses, and $75,000 for married taxpayers filing separate returns.) Thus, while the tax rate on capital gains is still capped at 15%, the tentative minimum tax increases because the reduced AMT exemption increases the total income that is subject to the AMT rates.

Example 9.4 Taxpayer with Large Capital Gains

Tommy Hawk is single with no dependents. In 2011, Tommy decided to quit farming, He sold his 70 acres of farmland but kept his 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 for $260,000. His income tax basis in the land was $30,000, so he had a $230,000 capital gain from its sale.

Tommy claims the $5,800 standard deduction, and his personal exemption deduction is $3,700. If Tommy had not sold the land, he would not owe any AMT. His AMTI would be $58,234 ($25,000 farm income – $1,766 SE tax deduction + $35,000 wages). His income subject to the AMT after subtracting his $48,450 AMT exemption would be $9,784, and he would have a $2,544 tentative minimum tax ($9,784 × 26% = $2,544), which is less than the $8,769 regular tax on his $50,500 taxable income.

However, the capital gain from the farmland sale increases his taxable income to $278,734 and his regular tax to $42,815. The capital gain is still taxed at the 15% rate, but its inclusion in his AMTI reduces his $48,450 AMT exemption to $6,892 and his AMT increases to $5,652.

Planning Pointer

Spread Capital Gains to More Than One Year

If large capital gains would cause the AMT, spreading them over more than one year can reduce or eliminate the additional liability. Spreading the gains can keep AMTI below the threshold for reducing the AMT exemption amount.

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

Capital gains can be spread out 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 being paid on an installment contract or the risk of a price decrease if you delay selling part of the assets.

Example 9.5 Spreading Capital Gains

Tommy Hawk from Example 9.4 sold his farmland for $260,000, but he entered into an installment contract that required the buyer to pay $130,000 in 2011 and $130,000 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 each year. He has $58,234 of ordinary income and claims the standard deduction and one personal exemption deduction for 2011. Tommy's AMT for 2011 is zero.

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

Itemized Deduction Limitations

The AMT calculation eliminates or limits several of the Schedule A (Form 1040) itemized deductions. They include the following four common itemized deductions.

1. State and local taxes (including property taxes, income taxes, and sales taxes) are not deductible at all 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-adjusted-gross-income (AGI) floor are not allowed for the AMT.

- Hobby activity deductions are allowed for regular tax purposes as a 2%-of-AGI-floor miscellaneous deduction to the extent of the income from the hobby activity, 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 that is **not** used to acquire, construct, or substantially improve the taxpayer's main home or second home is not deductible for AMT.
4. Medical and dental expense deductions 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 9.6 Hobby Expenses

Mia Bombardini, 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, Mia had $40,000 of revenue and $48,000 of expenses from her horse activity. The hobby loss rules limit her expense deduction for regular tax purposes to her $40,000 of revenue from the activity. The deduction is further reduced by 2% of her AGI. As a result, her taxable income is $27,000 and her regular income tax is $3,629.

Mia cannot deduct the $40,000 of horse expenses and certain other deductions when she computes her AMT. Consequently, Mia owes $1,604 of AMT in addition to her $3,629 regular tax.

Planning Pointer

Prepayment of Taxes

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

The AMT for corporations is similar to the AMT for individuals with a few 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 prior 3-tax-year periods do not exceed $7,500,000. (If the C corporation had only one prior tax year, the average annual gross receipts limit is $5,000,000.) Therefore, most small- and medium-sized farms that are operated as C corporations are not subject to the AMT.

Differences for C corporations that are subject to the AMT include the following:

1. Some preferences and adjustments taken into account in computing AMTI are different.
2. The AMT exemption is $40,000.
3. The tax rate used to compute the tentative minimum tax is 20%.

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. It has considered permanently increasing the AMT exemption amount and indexing it for inflation. Other potential solutions are increasing the AMTI threshold for phasing out the AMT exemption and repealing the AMT.

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