alternative minimum tax

The AMT was designed to prevent wealthy taxpayers from using tax loopholes to avoid paying taxes. Because historically the exemption from the AMT had not been automatically adjusted for inflation and certain common deductions were not allowed in computing the AMT, millions of middle class taxpayers were finding themselves subject to the AMT. However, Congress provided some annual relief in the recent past by installing "AMT patches" which increased the AMT exemption.

ATRA permanently increased the AMT exemption beginning in 2012 and provided for indexing of the exemption for 2013 and beyond. Since ATRA increased income tax rates for certain taxpayers beginning in 2013, fewer people may be subject to the AMT while paying a higher overall rate. Proper planning requires a 2-year analysis in order to determine the true benefits you can achieve.

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WHAT TRIGGERS THE AMT?

The AMT is computed separately from your regular tax. Using your regular taxable income as a starting point, adjustments are made to arrive at your alternative minimum taxable income ("AMTI"). Many deductions and tax credits that are used to calculate your regular tax are not deductible or allowable in computing AMTI. So, even though the AMT maximum tax rate is less than the regular maximum tax rate, your AMT liability may be higher than your regular tax. You will pay the higher of the regular tax or the AMT.

Chart 3 shows most of the adjustments necessary to calculate your AMTI. As the chart illustrates, certain deductions, such as state and local income taxes and real estate taxes, are not deductible when computing your AMTI. Other deductions, such as depreciation on business property, may be different for regular tax and AMT purposes. And some forms of income are exempt for regular tax purposes but taxable for AMT purposes. One example is the exercise of incentive stock options to the extent the fair market value exceeds the exercise price.

Tax Tip 5 demonstrates the high cost of being in the AMT.

Tax Tip 6 explains how state taxes on long-term capital gains and qualified dividends may trigger the AMT.

PRIVATE ACTIVITY BOND INTEREST

Tax-exempt interest on specified private activity bonds issued in 2009 and 2010 are no longer an item of tax preference and, therefore, not subject to the AMT. However, the interest on such bonds issued before 2009 and after 2010 is still subject to the AMT.

AMT RATES

For 2016, the 28% maximum tax rate applies to ordinary AMTI in excess of $186,300 for joint returns and unmarried individuals ($187,800 for 2017) and $93,150 if married filing separately ($93,900 for 2017) net of any allowable exclusion. Ordinary AMTI of $186,300 or less is subject to a tax rate of 26%. Net long-term capital gains and qualified dividends are taxed at the same maximum 20% rate for both the AMT and regular tax beginning in tax year 2013.

AMT EXEMPTION

Beginning in 2013, the exemption amount is indexed for inflation. For 2016, you are allowed an AMT exemption of up to $83,800 ($84,500 for 2017) if married filing jointly, $53,900 ($54,300 for 2017) if filing single or head of household or $41,900 ($42,250 for 2017) if married filing separately. Exemptions are fully phased out for taxpayers when their AMTI reaches $498,900 (married filing jointly), $337,900 (single or head of household) or $249,450 (married filing separately).

Be advised that while you are in the AMT exemption phase out range, your marginal AMT tax rate can be as high as 35%.

PLANNING FOR AMT SCENARIOS

Tax planning can help you determine whether or not you will be subject to the AMT. This can enable you to take steps to reduce your overall tax liability. Using Chart 3 to guide you, here are 3 possible AMT scenarios to plan for:

You are subject to the AMT in the current year, but don't expect to be next year:

- Defer until the following year any deductions that are not deductible for AMT purposes. Avoid the pitfall of automatically prepaying your state income taxes before the end of the year.

- Taxpayers with large itemized deductions that are disallowed for AMT but considered a direct expense that can be deducted when computing net investment income may want to consider taking such deductions in the current year, even if in the AMT. Expenses such as state and local taxes paid, investment fees, etc. are directly allocable to net investment income and can be used to lower the 3.8% surtax even if the deductions are not allowed for AMT purposes.

- Accelerate ordinary income into the current year to benefit from the lower AMT rate.

- Realize net short-term capital gains this year to benefit from the lower AMT rates, unless these gains will offset short-term losses next year or would otherwise be held long term.

- Delay exercising any incentive stock options ("ISOs") since you could wind up paying the AMT on the spread between the fair market value and the exercise price. If you already exercised the options, consider a disqualifying disposition as discussed in the chapter on stock options. Also, see the rule discussed later in this chapter that may offer some credit relief for the AMT resulting from the exercise of ISOs.

tax tip

5 THE HIGH COST OF THE AMT

Failing to consider the AMT and incorrectly timing the payment of some of your deductions can be costly. Let's say that before December 31, 2016, you paid the following expenses:

- $15,000 state estimated fourth quarter tax payment (due January 15, 2017),
- $10,000 in real estate taxes (not due until January, 2017), and
- $20,000 in charitable contributions that you could have delayed until 2017.

Income	Regular Tax After Year-End Payments	AMT
Earned income	$ 200,000	$ 200,000
Qualifying dividends	25,000	25,000
Long-term capital gains	175,000	175,000
Total income	**$ 400,000**	**$ 400,000**
Deductions		
State & local income taxes	$ 100,000	$ 0
Real estate taxes	20,000	0
Mortgage interest	50,000	50,000
Contributions	40,000	40,000
Investment advisory fees	25,000	0
Disallowance of advisory fees (2% of AGI)	(8,000)	0
3% AGI Floor	(2,661)	0
Net itemized deductions	**$ 224,339**	**$ 90,000**
Personal exemptions (married with 2 children) (after phaseouts)	4,536	0
Taxable income	**$ 171,125**	**$ 310,000**
Federal tax	**$ 14,374**	**$ 35,287**
Medicare Contribution Tax on net investment income	5,054	5,054
Total federal tax (including Medicare Contribution Tax on net investment income)	**$ 19,428**	**$ 40,341**

Because you must pay the higher of the two taxes, your tax will be $40,341 — that's $20,913 of AMT tax in excess of your regular tax. Therefore, you lost the full benefit from the prepayment of your state estimated tax and real estate taxes, as well as some of the benefit of prepaying charitable contributions.

You are not subject to the AMT in the current year and will be taxed at the regular tax rate of 39.6% but expect to be subject to the AMT next year:

- Prepay deductions that are not deductible for AMT purposes to get the full tax benefit in the current year rather than lose the tax benefit next year.
- Prepay your fourth-quarter state and local income tax estimate by December 31, as well as any projected remaining balance due on your current year's state/local income tax return that you would otherwise pay on April 15 of the following year.
- Prepay deductions that are deductible against the AMT, such as charitable contributions, to gain the benefit of the higher ordinary tax rate in the current year.
- Defer ordinary income, such as bonuses if possible, to the following year to take advantage of the lower AMT rate.
- Review your ISO awards to determine if you can exercise any shares before the end of the year. The exercise will be tax-free this year up to the extent of the break-even point between your regular tax and the AMT. In the following year, any exercises will result in an AMT liability based on the fair market value of the shares at the time of exercise over the exercise price.

You are not subject to the AMT in either year:

- You have avoided the AMT, but you still want to reduce your regular tax liability in the current year. Turn to the chapter on tax planning strategies for year-end planning ideas that can minimize your tax exposure.

AMT CREDIT CAN REDUCE FUTURE TAXES

If you pay the AMT, you may be entitled to a tax credit against your regular tax in a subsequent year. You qualify for an AMT credit based on "deferral items" that contributed to your AMT liability. The most common deferral items are depreciation adjustments, passive activity adjustments and the tax preference on the exercise of ISOs. Other deductions, such as state and local income taxes and investment fees, are called exclusion items. You cannot get an AMT credit from these deductions. The AMT illustrated in Tax Tip 5 would not create an AMT credit since none of the adjustments are deferral items.

The reason a deduction is classified as a deferral item is because over time you will end up with the same total deductions for both regular tax and AMT purposes. As an example, a depreciation difference is a deferral item if it is calculated using a different asset life and method for AMT purposes then used for regular tax purposes. However, over the life of the asset the total depreciation will be the same under either tax computation. Special rules apply for bonus depreciation. See the chapter on business owners and depreciation deductions.

tax tip

6 LONG-TERM CAPITAL GAINS AND QUALIFYING DIVIDEND INCOME CAN PUT YOU INTO THE AMT

Long-term capital gains and qualifying dividend income can cause you to be subject to the AMT, even though both are taxed at the maximum tax rate of 20% for regular tax purposes and for the AMT. The reason for this is that when you pay state and local taxes on the income, which reduces your regular tax liability, these taxes are not deductible in computing your AMT. Therefore, your AMT taxable income is higher than your regular taxable income.

As an example, let's say you file a joint return and your income only included a long-term capital gain of $600,000 and, as a New York City resident, your state and city income tax was $60,000. Ignoring all other deductions, exemptions, phaseouts and rate differentials, your regular taxable income would be $540,000 after the $60,000 deduction. At the maximum tax rate of 20%, your regular tax would be $108,000. Your AMT liability would be $120,000 ($600,000 taxed at the same maximum rate of 20%) because you are not allowed a deduction for state and local income taxes. Therefore, you would pay the higher of the 2 taxes (an additional cost of $12,000). Keep in mind that not all of the long-term capital gains (regular or AMT) will be taxed at the 20% rate, since there is also a 15% rate applied up to certain income thresholds.

If you find yourself in this tax situation, avoid paying your state and local income taxes in the year of the sale. To the extent possible, consider deferring the payments until next year if there is a possibility that you will not be in the AMT and you may therefore receive a federal tax benefit.

Keep in mind that if you are subject to the Medicare Contribution Tax on net investment income, consideration should be given to paying expenses that are allocable in arriving at net investment income even if they are not deductible for AMT purposes.

chart 3

AMT VS. REGULAR TAX

Description	Deductible in Computing: Regular Tax	Deductible in Computing: AMT	Taxable for AMT Only	Other AMT Differences
State and local income taxes (non-business)	•			
Real estate taxes (personal)	•			
Qualified Motor Vehicle Tax (State or local sales tax or excise tax on purchase)	•			
Investment interest expense	•	•		
Charitable contributions	•	•		
Investment advisory fees	•			
Employee business expenses (W-2)	•			
Mortgage interest on:				
• Qualified acquisition and equity debt up to $1,000,000 used to buy, build, or improve your residence	•	•		
• Equity debt (up to $100,000) not used to improve your residence	•			
Note: *Interest on acquisition debt in excess of $1 million and equity debt over $100,000 is not deductible as mortgage interest, but the debt is subject to the interest tracing rules to determine if deductible as interest on other debt, such as investment interest.*				
Medical expenses in excess of 10% of AGI*	•	•		
Exercise of incentive stock options (to the extent the fair market value exceeds the exercise price)			•	
Depreciation (subject to different AMT rules)				•
Gain or loss on disposition of certain assets, including sale of small business stock				•
Passive activity adjustments				•
Interest on private activity bonds issued before 2009 and after 2010				•
Net operating losses (subject to different AMT rules)				•

**For regular tax purposes, the medical expense threshold is 7.5% for any tax year beginning after December 31, 2012 and before January 1, 2017 for taxpayers who have attained age 65 for close of such year. The threshold increases to 10% for all beginning January 1, 2017.*