ALTERNATIVE MINIMUM TAX ISSUES

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BIOGRAPHY OF
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C. Anthony Phillips is a partner in the certified public accounting firm of Phillips & Company, practicing in the areas of federal, state and local tax compliance for individual, partnership, corporation and fiduciary taxpayers. He is also president of Downstream Exchange Company which has acted as an accommodator in thousands of tax deferred exchanges.

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He received his Bachelor of Science degree from Drexel University in Philadelphia and holds two master degrees from the University of Southern California – one in Business Administration in Finance and the other in Business Taxation.

He has been a certified public accountant since 1965 and has taught real estate tax classes at various city colleges. Since becoming a Department of Real Estate approved instructor and being named to the California Association of REALTORS® State Faculty, he has given numerous seminars on tax deferred exchanges and the use of an accommodator, as well as other real estate tax related subjects. He has been a speaker on various aspects of tax deferred exchanges at the majority of the annual conferences of the Federation of Exchange Accommodators.

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Historically, Congress has attempted to pass legislation in order to ensure that every taxpayer pays a certain amount of income taxes, no matter how many tax incentives and other special allowances the taxpayer might utilize. One of these pieces of legislation that Congress passed is the Alternative Minimum Tax (AMT) (Internal Revenue Code § 55). The AMT is a second calculation of tax that is made on a taxpayer's tax return, originally passed with the intent to ensure that every taxpayer with substantial economic income pays meaningful amounts of tax.

In 1966 statistics showed that 155 individuals with adjusted gross income exceeding $200,000 succeeded in entirely eliminating any income tax liability by extensive use of allowances authorized by the Internal Revenue Code. In 1969, members of Congress received more constituent letters about these 155 taxpayers than about the Vietnam War. Although the revenue loss from these 155 taxpayers was not overwhelming, Congress believed that their immunity threatened taxpayer morale and seriously undermined the belief of taxpayers that all taxpayers, especially high-income individuals, paid their fair share of the tax burden. In response Congress imposed a "minimum tax" in addition to the regular tax, a flat tax of 10% on the tax preference items above a $30,000 exemption.

In 1976 Congress raised the minimum tax rate to 15% and the exemption became the greater of $10,000 or the (now repealed) "regular tax deduction." In 1978 Congress enacted an alternative minimum tax, treating capital gains and adjusted itemized deductions as preference items. It applied to non-corporate taxpayers if the recomputed tax exceeded the regular tax, including the 15% add on minimum tax. In 1982, the 1969 add-on minimum tax was restricted to corporations and the alternative minimum tax assumed a much broader significance for individuals. Then in 1986 the add-on minimum tax for corporations was eliminated and the AMT was strengthened and extended to all taxpayers. In 2005 the 2005 Tax Increase Prevention and Reconciliation Act (TIPRA), was signed into law May 17, 2006, increasing the AMT exemption amounts.

Today the AMT is still regular taxable income, adjusted to eliminate the benefits of many tax allowances that cause taxable income to diverge from economic income. It is imposed at a rate somewhat lower than the regular tax rates, but on a base that is much broader than the regular tax base. The exemption amounts have never been fully indexed for inflation and the adjustments are ever broadening; therefore, more and more middle-income taxpayers have to pay the AMT.

Prior to the 2005 changes to the AMT, the Tax Policy Institute predicted that the AMT was expected to jump to 20 million taxpayers by 2010 because of inflation, and that within 10 years 35 million taxpayers could be liable for the AMT. The Tax Policy Institute also believed that the AMT was on the verge of dominating our income tax system because it was estimated that by 2008 the AMT would raise approximately $11 billion in taxes. The Treasury Department estimated that close to 50 million taxpayers could be liable for the AMT within 10 years. The Tax Policy Center estimates that by 2010, 49% of the taxpayers liable for the AMT will make between $75,000 and $100,000 (in 2005 dollars). The non partisan Congressional Budget Office forecasts that if Congress does nothing, 65% of individual income tax liability would be generated by AMT compared with about 2% today.

According to Senator Max Baucus, D-Montana, virtually all upper-middle class families with two or more children will be paying the AMT by 2010. As these statistics show, taxpayers now

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affected by the AMT are no longer the high-income taxpayers originally targeted by Congress's creation of the AMT.

According to Chuck Grassley a Republican Senator representing Iowa and ranking member of the Senate Finance Committee, AMT has failed in everyway, except for the ability to raise very large sums of money to feed government spending. Ironically, the AMT has not achieved its original objective. According to IRS analysis of 2004 tax year data, 2,833 taxpayers with incomes of $200,000 or more escaped their entire federal income tax liability.

The consumer price index increase has also contributed to the AMT affecting more middle-income taxpayers. The consumer price index increased 96% from 1983 to 2005. From 1983 to 2005, the amount of AMT income exempt from AMT tax for joint and married taxpayers filing separate returns increased by 45%, and the amount of AMT income exempt from AMT tax for unmarried individual returns increased by 34%. However, the 2005 Tax Increase Prevention and Reconciliation Act (TIPRA) increased the AMT exemption amounts for 2006 tax returns. Taking the 2006 changes into consideration, the amount of AMT income exempt from AMT tax for joint and married taxpayers filing separate returns from 1983 to 2006 increased by 56%, and the amount of AMT income exempt from AMT tax for unmarried individual returns increased by 42%.

The AMT affects a taxpayer's return in many ways. The taxpayer loses the personal exemption for himself and his spouse, if married, and for each child. For 2004, the personal exemption was $3,100 and in 2005 it went up to $3,200. Therefore, a married couple with three dependent children could lose $15,500 in exemptions in 2004 and $16,000 in 2005 due to the AMT. If the taxpayer doesn't itemize his deductions, he would lose the ability to claim the standard deduction. For 2004, that would mean a loss of $9,700 for married couples filing jointly and $4,850 for single taxpayers. For 2005, the standard deductions were $10,000 for joint filers and $5,000 for singles. Also, the AMT only allows a taxpayer to deduct medical expenses in excess of 10% of the taxpayer's Adjusted Gross Income, instead of the conventional 7.5%. With the AMT the taxpayer must add the 2.5% difference back to their income. With the AMT, the taxpayer also loses deductions for state and local taxes paid, as well as losing the ability to deduct any miscellaneous itemized deduction.

Qualified dividends and long-term capital gains are now taxed for federal tax at rates no higher than 15% for purposes of both the ordinary income and alternative minimum taxes. However, the extra income could accelerate or even wipe out the amount of income the taxpayer can exempt from the AMT ($58,000 for married joint filers, $40,250 if you're single). In addition to losing deductions under the AMT, the taxpayer may gain a source of taxable income. If the taxpayer is subject to the AMT, he has to include interest from certain tax-exempt private-activity bonds as part of his alternative minimum taxable income. These bonds pay for such things as certain types of housing projects, airports, and industrial parks. Normally, if the taxpayer exercises incentive stock options (ISOs) and decides to hold the stock for at least two years after the options are granted, and one year after the stock is acquired upon exercise and meets certain other requirements, he may be able to defer tax on the capital gain until he sells. However, if subject to the AMT, alternative minimum taxable income is usually increased by the amount by which the fair market value of the stock at the time of exercise exceeds the option exercise price.

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However, there are ways for a taxpayer to minimize his AMT exposure. A taxpayer should always consult a tax professional before taking any of the recommended actions. The taxpayer should plan for the years in which he takes capital gains. If married and filing jointly in 2006 with an income below $150,000, the taxpayer can exclude the first $62,550 when calculating your income for purposes of the AMT. However, a large capital gain, from the sale of real property, might push the taxpayer's alternative minimum taxable income over $150,000, wiping out all or part of that $62,550 exemption. (The exemption starts to phase out for married couples filing jointly at $150,000 of income and disappears completely at $400,200.) The taxpayer may be able to manage this problem by delaying a sale into the next year or using an installment sale to spread the gains and potential tax liability over a number of years. For example, if the taxpayer has appreciated securities that would result in a $50,000 capital gain, he might consider spreading the sale out over two to three years. Proper timing could allow him to offset the two if the taxpayer has no other non-recurring deductions.

Another way for a taxpayer to minimize his potential AMT exposure is to forecast the year in which to take deductions. Assuming the taxpayer may be subject to the AMT next year, the taxpayer may want to consider paying his local and state tax bills before the end of the current year. Then the taxpayer would gain a deduction that may otherwise be lost next year. The taxpayer could also group together other expenses – such as interest on a second mortgage and investment and tax preparation fees – and pay them this year. If the taxpayer would be subject to the AMT, he may not be able to deduct those payments next year. If a taxpayer finds himself paying the AMT tax, he should consult with a tax professional who can give him more details on the above and other strategies for managing his AMT exposure.

Appendix A

1) How the Alternative Minimum Tax is Computed

a. First you compute the regular income tax (Form 1040):

Income:
+ Wages
+ Taxable Interest
+ Qualified Dividends
± Self-employment income
± Capital Gains or Losses
+ State & Local Refunds
± Other Income/Loss

= Total Income
- Less Adjustments to Income

= Adjusted Gross Income
- Greater of Allowed Itemized Deductions or Standard Deductions

= Taxable Income Prior to Personal Exemptions

- Personal Exemptions

= Regular Taxable Income
Calculate Regular Tax Based Upon Regular Taxable Income

b. Then you compute the Alternative Minimum Tax (Form 6251)

Start with Taxable Income Prior to Personal Exemptions
Generally add the following:
Medical and dental expenses deducted on Schedule A
Taxes deducted on Schedule A
Home mortgage interest adjustment from Schedule A
Miscellaneous deductions deducted on Schedule A
Itemized deduction limitation
Subtract any State or local tax refunds
Interest from specified tax exempt private activity bonds
Subtract the overall limitation on itemized deductions
Sometimes add the difference between regular tax and AMI tax:

Investment interest expense
Depletion
Net operation loss deduction
Qualified small business stock
Exercise of incentive stock options
Estates and trusts
Electing large partnerships
Disposition of property
Depreciation on assets placed in service after 1986
Passive activities
Loss limitations
Circulation costs
Long-term contracts
Mining costs
Research and experimental costs
Income from certain installment sales before 1/1/87
Intangible drilling costs preference
Other adjustments
Less Alternative tax net operation loss deduction

= Alternative minimum taxable income
- Exemption
Amount on which AMT tax is applied

Calculate AMT tax based upon the amount on which AMT tax is applied

c. **Pay the AMT tax if higher than regular tax**

Appendix B

Explanation of Significant Adjustments for the Alternative Minimum Tax

a. Medical and dental expenses deducted on Schedule A: Medical expenses are limited to the **smaller** of the amount deducted in computing regular taxable income or 2 1/2 % of adjusted gross income.

b. Taxes deducted on Schedule A: Add back any **Property taxes, state income taxes, sales taxes and any other taxes** deducted in computing regular taxable income.

c. Home mortgage interest adjustment from Schedule A: **Interest on home equity indebtedness** used to pay for school, a car, a vacation, or anything else other than a home improvement project. Also, interest on debt incurred to acquire, construct, or substantially improve a second residence is deductible for AMT purposes **only if the residence is a house, apartment, condominium, or mobile home not used on a transient basis.** The principal effect of the latter rule is to deny AMT deductions for interest debt incurred in **purchasing yachts and other boats used as vacation homes**.

d. Miscellaneous deductions deducted on Schedule A: **No deduction is allowed for AMT purposes for "miscellaneous itemized deductions,"** such as employee business expenses and investment expenses.

e. State tax refund: **Subtracted** in the calculation of AMT.

f. Subtract the overall limitation on itemized deductions: If your adjusted gross income exceeds a specific amount, your total itemized deductions are limited. You are allowed to **deduct** the amount of the limitation in the calculation of your AMT taxable income.

g. Interest from specified tax exempt private activity bonds: Certain interest on bonds issued by state and local governments must be **added back** to AMTI as an item of tax preference.

h. Charitable contributions of appreciated property: If a deduction is allowed for regular tax purposes for the fair market value of appreciated property, the difference between the cost basis and fair market value is **added back** for AMT purposes.

i. Incentive stock options (ISOs): You have to **add** to the calculation for AMT the amount by which the fair market value of the stock at the time of exercise exceeds the option exercise price.