Financial Planning Implications of the Alternative Minimum Tax

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Financial Planning Implications of the Alternative Minimum Tax (AMT)

Outline

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- Managing the AMT Exemption

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Financial Planning Implications of the Alternative Minimum Tax (AMT)

AMT – What Is It?

- Second (alternative) tax system
- Taxpayers must pay the greater tax bill – their regular tax liability or their minimum tax due under the AMT system
- Used to ensure that high income taxpayers always have at least SOME tax liability
- Established in 1970 in response to a Treasury report that revealed 155 high-income taxpayers (>$200,000 of income) paid NO income tax in 1966.
- Nearly 5 million taxpayers affected even with AMT patch

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Financial Planning Implications of the Alternative Minimum Tax (AMT)

AMT – How does it work?

- Take regular tax system TAXABLE INCOME before deducting exemptions
- Add/subtract adjustments to taxable income (alternative methods to calculate gains, losses, and deductions)
- Add preference items (specified items that taxpayers receive preferential treatment for under the regular tax system)
- Arrive at Alternative Minimum Taxable Income (AMTI)
- Subtract AMT exemption ($78,750 for married couples, $50,600 for singles) from AMTI
- Apply tax rates of 26% on first $175,000 of remaining AMTI, and 28% on all remaining AMTI. (now indexed!)

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AMT - Adjustments

Common individual AMT adjustments include:

- No deduction for miscellaneous itemized deductions subject to 2% floor
- No deduction for state, local, and foreign tax payments
- Medical expense deductions recomputed with 10% floor
- No deduction for "home equity indebtedness"
- No standard deduction allowed (if taxpayer did not itemize)
- Inclusion of Incentive Stock Option deferred tax liability at exercise (with subsequent adjustment on sale)

AMT - Adjustments

Some less common adjustments might include:

- Alternative (slower) depreciation schedules for business property
- Alternative gains/losses on business property with basis computed under AMT depreciation schedules
- Alternative Tax Net Operating Loss rules

- Certain AMT adjustments can create a Minimum Tax Credit (MTC)

AMT – Minimum Tax Credit

- AMT adjustments which affect the TIMING of income recognition (such as Incentive Stock Options) create a minimum tax credit (MTC).
- The MTC is a tax credit against your future regular income tax, *to the extent that it does not create AMT* (i.e., your regular tax can only be reduced until it equals your tentative minimum tax)
- The MTC is used so that you do not recognize large gains for AMT one year, and then recognize large gains AGAIN on the SAME property in a subsequent year for regular tax purposes.

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AMT – MTC Example

- In 2003, Robert exercises 1,000 ISOs with a strike price of $50/share and a current value of $75/share. Robert recognizes a $25/share gain, or $25,000, for AMT purposes.
- In 2004, Robert sells his 1,000 shares for $75. For regular tax purposes, his cost basis is $50, so THIS year he recognizes $25,000 of REGULAR taxable income (capital gains) for the same stock.
- To avoid ultimately paying taxes TWICE on the SAME $25/share gain, Robert will have a minimum tax credit from 2003 to help offset his 2004 tax liability.

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AMT – Tax Preference Items

- Common individual AMT Tax Preference Items include:
  - Tax-exempt interest on private activity bonds
  - Certain oil & gas depletion and intangible drilling cost deductions
- AMT Tax Preference Items might also include:
  - Excess depreciation on certain business property

AMT – Example

- John and Jane Doe earn $175,000 in compensation/income and have three children. They contribute $5,000 to charities, pay acquisition mortgage interest of $15,000 and $5,000 of home equity interest, real estate taxes of $9,000, and $15,000 of state income taxes.
- Under the regular tax system…
  - Itemized deductions = $49,000
  - Exemptions = $3,950 x 5 = $19,750
  - Taxable income = $106,250
  - Regular tax liability = $18,275

AMT – Example

- Under the AMT system…
  - Taxable Income before exemptions = $106,250 + $19,750 = $126,000
  - Add-back real estate taxes & state income taxes & home equity interest
  - AMTI = $126,000 + $9,000 + $15,000 + $5,000 = $150,000
  - AMT exemption = $82,100
  - Tentative minimum tax = $150,000 - $82,100 = $72,900 * 26% = $18,954
  - Since tentative minimum tax = $18,954 and regular tax liability = $18,275, then AMT of $18,954 - $18,275 = $679 is due.

AMT – Example

	Regular Tax System	AMT System
Income	$175,000	$175,000
Deductions	$49,000	$20,000
Exemptions	$19,750	$82,100
Taxable Income	$106,250	$72,900
Total Tax	$18,275	$18,954

AMT Liability = $18,954 - $18,275 = $679

AMT – Potential Exposure

- Common AMT adjustments and tax preference items that cause AMT exposure:
  - High state income tax rates (e.g., Arkansas, California, Hawaii, Idaho, Iowa, Maine, Maryland, Minnesota, New Jersey, New York, North Carolina, Oregon, South Carolina, Vermont, Wisconsin, and the District of Columbia)
  - High property tax rates and/or substantial amount of property that will be taxable
  - High number of dependents (e.g., children, dependent parents)
  - High miscellaneous itemized deductions
    - Investment management fees
    - Tax preparation fees
    - Variable annuity losses
    - Unreimbursed employee business expenses

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AMT – Potential Exposure

Potential Exposure to AMT (2014)		
	Amount of Adjustments & Preferences that may cause AMT to apply	
Regular Taxable Income	Joint	Single
$50,000	$57,456	$34,939
$100,000	$46,379	$30,856
$150,000	$36,971	$23,933
$200,000	$30,048	$18,581
$300,000	$21,421	$12,866
$400,000	$15,707	$35,699
$500,000	$30,010	$77,128

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AMT – Potential Exposure

- Example for evaluating potential exposure:
  - Sam and Jennifer Jackson are married with two dependent children.
  - Their income includes $175,000 of employment income, $15,000 of interest, and $10,000 of capital gains.
  - Their deductions include four personal exemptions ($3,950 each), $7,000 for state income taxes, $5,000 for real estate taxes, $15,000 of mortgage acquisition debt, and $5,000 of home equity interest used to refinance credit card debt.
  - Their total income is $200,000. Their total deductions are $47,800. Thus, their taxable income is $152,200.
  - Their AMT adjustments total $32,800.
- Are they potentially subject to the AMT?

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AMT – Potential Exposure

- Taxable income is $152,200, and AMT adjustments total $32,800.

Potential Exposure to AMT (2014)		
	Amount of Adjustments & Preferences that may cause AMT to apply	
Taxable Income	Joint	Single
$50,000	$57,456	$34,939
$100,000	$46,379	$30,856
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AMT Planning Implications

- Where are you in "Tax World"?
  - Regular-Tax-Land
  - On The Border
  - AMT-Land

AMT Planning Implications

Regular Tax-Land

- Certain AMT Adjustment items can create a minimum tax credit (MTC) to be applied in future years (subject to restrictions). Be certain to fully claim and apply the MTC if eligible, including long-term unused MTCs. Check for prior MTCs not tracked/claimed.
- Carefully plan for exercise of Incentive Stock Options, including impact of subsequent sales

AMT Planning Implications

On The Border

- Focus on year-by-year timing of state (and other) tax payments and state tax refunds.
- Move income into AMT year if it will take advantage of lower AMT marginal tax rate
- Make payments for medical expenses and/or miscellaneous itemized deductions in current/future non-AMT years
- Choosing to itemize, even when less than the standard deduction (particularly for the increased standard deduction for those over 65)
- Consider whether dependents might be able to claim themselves on their own tax returns; evaluate overall family tax liability.

AMT Planning Implications

AMT-Land

- Properly evaluate after-tax cost of borrowing that will be considered “home equity indebtedness”
- Examine portfolio for private activity municipal bonds and properly evaluate after-tax yield
- Avoid large unreimbursed employee expenses by obtaining reimbursement or negotiating expense payment concurrent with salary reduction.
- Take advantage of the AMT tax rates

AMT Planning Implications

AMT-Land

- Be certain that any expenses that can be claimed as business deductions are in fact claimed as such (e.g., partial property taxes, property interest expenses)
- Keep thorough and proper books of business property depreciation under AMT system to take advantage of later-years additional depreciation and adjusted gains
- Evaluate business deductions (e.g., depletion, certain types of depreciation) to determine whether alternative AMT elections may be useful.
- Examine the effect of net operating losses under the regular tax system AND the AMT tax system

AMT Planning Implications

Managing the AMT exemption

- Managing the AMT exemption in AMT land
  - The AMT exemption is a “standard deduction” that all AMT taxpayers receive, unless it is phased out
  - For AMT taxpayers, virtually all deductions are independent of income levels (except for medical expense deductions)
  - As income increases, managing the AMT exemption is the primary tax planning opportunity

AMT Planning Implications

Managing the AMT exemption

- AMT Exemption Phaseout: $0.25 for every $1 of AMTI in excess of $150,000 (for Married Filing Jointly; $112,500 for Single taxpayers)
- Rising income can cause some or all of the AMT exemption amount to be phased out
  - When phased out, this tax deduction is permanently lost for the year!
  - As additional income is received, marginal tax rates are higher as a result of the phaseout

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AMT Planning Implications

Managing the AMT exemption

- AMT exemption phaseout example – rising income:
  - AMT tax rates: 26% and 28%
  - AMT exemption phased out for each $1 of capital gains: $0.25
  - Additional tax due because of AMT exemption phase-out: $0.25 x 26% = $0.065, or 6.5%
  - Total effective tax rate due to additional income: 26% + 6.5% = 32.5%
  - If in the 28% AMT bracket, 28% + 7% = 35%!

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AMT Planning Implications

Managing the AMT exemption – Capital Gains

- Carefully evaluate the consequences of creating large capital gains.
  - Long-term capital gains are STILL taxed at preferential rates; however
  - Capital gains can cause NON-gains income to become subject to AMT!
  - Capital gains can trigger the phase-out of the AMT exemption, causing a higher marginal tax rate!

AMT Planning Implications

Managing the AMT exemption – Capital Gains

- AMT exemption phaseout example – capital gains:
  - Capital gains tax rate: 15%
  - AMT exemption phased out for each $1 of capital gains: $0.25
  - Additional tax due because of AMT exemption phase-out: $0.25 x 15% = $0.0375, or 3.75%
  - Total effective tax rate due to capital gains: 15% + 3.75% = 18.75%!
  - Phaseout first allocated against 26% or 28% income, total effective tax rate due to capital gains may be 15% + 6.5% = 21.5% or even 22%!

AMT Planning Implications

Managing the AMT exemption – Strategies

- AMT exemption strategies:
  - Spread income to remain below the exemption threshold
    - Focus on keeping AMTI below $150,000 as much as possible
  - Consolidate income when the exemption threshold has already been exceeded
    - “No further harm” can be done
    - Add income in high income years to reduce AMT exemption phaseout exposure in future years

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AMT Planning Implications

- AMT Summary Action Steps:
  - Work closely from year to year!
  - Perform multi-year projections under regular and AMT tax systems!
  - Examine potential transactions BEFORE they occur and BEFORE the end of the year!
  - Bear in mind the AMT exemption!
  - Evaluate potential exposure ahead of time!
  - Make tax planning decisions based on what “tax land” you’re in!
  - Write your Congress-person!

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