



TAX SAVING STRATEGIES NEWSLETTER

September 2007 #153

DEALING WITH THE ALTERNATIVE MINIMUM TAX—FOR INDIVIDUALS

Overview: According to a report from the National Taxpayer Advocate in December 2003, the Alternative Minimum Tax (AMT) is “the #1 most serious problem” for individuals.” Congress put the AMT into law in 1969 to prevent wealthy individuals from avoiding taxes. But, today many average taxpayers are being hit by the AMT. Why? Because the exemption amount has not been adjusted for inflation and the number of tax preferences targeted by Congress has increased. Also, Congress has lowered regular taxes but has not lowered the AMT. You pay the higher of the two!

What is the AMT? The AMT is an alternative way of figuring your tax. Income exempt from tax under the regular tax system is taxed for AMT and some deductions allowed under the regular tax system are not allowed for the AMT. **The AMT is a mechanism to take back certain tax savings allowed under the regular tax system for tax favored income and deductions.**

How can I tell if I will have to pay the AMT? Unfortunately there is no easy formula to determine if you have to pay the AMT. However, as a rule of thumb you may have to pay the AMT if your

taxable income is greater than the AMT Exemption Amount (see below) and you have large amounts of items that are treated differently for the AMT than for regular tax purposes. See below for a list of Common Items Treated Differently for AMT than for Regular Tax Purposes.

How is the AMT computed? The AMT is a tax in addition to the regular income tax. The AMT calculation starts with your regular taxable income and itemized deductions and adds some income not taxable for regular tax purposes and eliminates some deductions allowed for regular tax purposes. What is left is called the Alternative Minimum Taxable Income (AMTI). The AMT Exemption Amount (see below) is subtracted from the AMTI to arrive at the amount of income subject to the AMT. The amount left after subtracting the AMT Exemption Amount is taxed at rates of 26% and 28% depending on your level of income. **You pay the higher of the regular tax or the AMT.** If the AMT is higher than the regular tax, the AMT is the difference. You pay the regular tax plus the AMT.

AMT Exemption Amount: The AMT Exemption Amount varies according to your filing status and tax year. For 2006

the AMT Exemption Amounts were: \$62,550 for married filing jointly and surviving spouses; \$42,500 for singles; and \$31,275 for married filing separately. **The exemption amount is reduced by 25% of the amount that your AMTI exceeds:** \$150,000 for married filing jointly and surviving spouse; \$112,500 for single; and \$75,000 for married filing separately.

AMT Planning

Planning around the AMT is mainly done by timing. Timing when you receive income subject to AMT but not regular tax and timing when you pay deductions which are not allowed for AMT purposes.

If you are subject to the AMT, you want to 1) defer the recognition of income subject to AMT and 2) defer expenses which are deductible for regular tax purposes but not for AMT.

If you have capital gains, they can cause you to pay AMT. Capital gains are taxed at the same rate under the regular tax system and the AMT. The problem arises when capital gains increases your AMTI so that you lose the AMT exemption. (See AMT Exemption Amount above) If you are thinking of selling investment property or your residence, figure out if the gain will put you into AMT territory. If so, try to spread the gain over more than one year. For instance, use an installment sale.

Common Items Treated Differently for AMT than for Regular Tax Purposes

The following are common items encountered by many taxpayers that are treated differently for the AMT than for regular tax purposes.

- The most common type of income which is taxed for AMT purposes and not for regular tax purposes is the bargain element of Incentive Stock Options (ISO). If you are subject to AMT and you are going to exercise an ISO, consider spreading the exercise over a number of years.
- Income from tax exempt private activity bonds is taxable for AMT purposes.
- Personal exemptions are not deductible.
- The standard deduction is not allowed.
- Medical expenses must exceed 10% of AGI rather than 7.5% of AGI. If you will have deductible medical expenses, try to pay them in a year that you will not be subject to the AMT. Or, take advantage of a pre-tax cafeteria plan if your employer offers one. If you pay medical bills through the plan, the diverted income no longer is included in taxable wages, and the medical expenses are no longer itemized deductions.
- Interest on loans secured by your residence that were not used to purchase, build or improve the residence is not deductible.

- State and local taxes are not deductible—income taxes, sales taxes, real and personal property taxes.
- Miscellaneous itemized deductions are not deductible. Time the payment of unreimbursed business expenses and miscellaneous itemized

deductions (such as unreimbursed employee business expenses and deductible legal expenses) so that they will not be paid in a year that you will be subject to the AMT.

Something to Think About

Section 168(i)(2)(B) of the Internal Revenue Code limits depreciation deductions for "computers and peripheral equipment." Understandably, it must define the term—which they did as follows: (B) COMPUTER OR PERIPHERAL EQUIPMENT DEFINED. -- For purposes of this paragraph--(i) IN GENERAL. -- The term "computer or peripheral equipment" means--(I) any computer, and (II) any related peripheral equipment.

President Reagan included this sentence in his speeches as an example of the Code being undecipherable. During his and subsequent administrations, we've seen 121 tax bills pass Congress. At least a dozen involved "simplification." However, this sentence is still in the tax code. Internal Revenue Code Section 509(a), which defines private foundations, reads: "For purposes of paragraph (3), an organization described in paragraph (2) shall be deemed to include an organization described in section 501(c)(4), (5), or (6) which would be described in paragraph (2) if it were an organization described in section 501(c)(3).

We hear a lot about how the tax system should tax the rich more than others. People should pay according to their ability to pay. Appropriately then, section 280F limits depreciation on "luxury" automobiles. That sounds fair, until you learn that, pursuant to section 280F(a)(1)(A)(iii), a "luxury automobile" is one costing over \$12,760.41.

This information is provided with the understanding that the publisher is not engaged in rendering legal, accounting, or other professional advice and assumes no liability whatsoever in connection with its use. Because tax laws are constantly changing, and are subject to differing interpretations, we urge you to do additional research before acting on the information contained in this newsletter.

This information is not intended or written to be used, and it cannot be used by a taxpayer, for the purpose of avoiding penalties that may be imposed on the taxpayer. I am required by Internal Revenue Service Circular 230 to inform you that, unless otherwise expressly indicated, any federal tax advice contained in this communication, including attachments and enclosures, is not intended or written to be used, and may not be used, for the purpose of (i) avoiding tax-related penalties under the Internal Revenue Code or (ii) promoting, marketing or recommending to another party any tax-related matters addressed herein.