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AMT-What is it and why should you care?

First enacted in 1969, the Alternative Minimum Tax (AMT) was designed to ensure that high-income taxpayers, who had historically benefited from various tax preference items under the regular tax system, pay at least a minimum amount of tax each year. Today, the AMT is becoming a tax trap for the middle class. The U.S. federal income tax has both a personal and a corporate AMT. The AMT for individuals is addressed here.

Understanding AMT

The best way to understand the AMT is to view it as a separate tax system. It has its own set of rates and its own rules for deductions, which usually are less generous than the regular rules. To calculate AMT, you start with your AGI, add or subtract any adjustments allowed under AMT rules and add back preferences to arrive at Alternative Minimum Taxable Income (AMTI) for AMT purposes. Then you deduct flat exemption amounts and re-compute the tax (under a two-tiered rate) on the totals. If the result is more than your regular tax liability (before certain credits), you must pay this amount in addition to your regular tax liability.

Adjustments & Preferences:

Certain tax benefits available under the regular tax system, such as Miscellaneous Itemized Deductions and the deduction of State Income Taxes paid, are reduced or eliminated when computing your AMTI. Here are a few items of adjustments and preferences, which might cause liability under the AMT; it is not meant to be a complete list.

- **Standard deduction:** Although the AMT usually hits higher-income folks, this widely used deduction can contribute to AMT liability.
- **State and local taxes:** Not Allowed. Add back any taxes deducted on Schedule A.
- **Medical and dental expenses:** Amounts over 10% of AGI are deductible. Add back 2.5% of AGI or actual amount of medical and dental expenses deducted on Schedule A, whichever is less.
- **Miscellaneous itemized deductions:** Not Allowed. Add back any amounts deducted on Schedule A.
- **Incentive stock options:** Difference between amount paid to acquire the stock under the incentive stock option and the fair market value of the stock must be added for AMT unless the stock is sold later in same year. For example, if you exercised an option to buy 100 shares of stock for $3 a share and the stock was trading at $10, the spread would be $7 a share, or $700. Under the regular rules, you wouldn't pay current taxes on that amount, but under the AMT, it's considered income.
- **Home Mortgage Interest:** If you borrowed against your home for some purpose other than expenses related to the home, the interest deduction won't be allowed under AMT.

- **Tax-exempt interest (from private activity bonds issued by state or local governments after August 7, 1986):** Interest otherwise exempt from the regular income tax might not be for the AMT. Income may be reduced by allocable expenses that were not deductible on Form 1040.
- **Depreciation prior to 1987:** Amount of depreciation on real property and leased personal property in excess of amount allowed under straight-line method must be added back for AMT.
- **Depletion:** Add back excess percentage depletion allowed over the adjusted basis of the property.

AMT Exemption:

Finally, you get to deduct the AMT exemption. *The Tax Increase Prevention and Reconciliation Act of 2005 (TIPRA) increased the AMT exemptions for 2006* details of which are as follows:

Filing status	**Maximum exemption**	**AMTI exemption phaseout threshold**
Married filing jointly or qualifying widow(er)	$62,550	$150,000
Single or head of household	$42,500	$112,500
Married filing separately	$31,275	$75,000

Your exemption phases out if your AMTI exceeds the thresholds indicated above. More specifically, your exemption is reduced by 25 percent of the amount by which your AMTI exceeds the applicable threshold for your filing status.

After subtracting your exemption amount, multiply the remainder by the applicable AMT rate. This tax rate is:

- 26 percent on amounts up to $175,000 ($87,500 for taxpayers filing as married filing separately)
- 28 percent on amounts above $175,000 ($87,500 for taxpayers filing as married filing separately)

Generally, the resulting figure is your Tentative Minimum Tax (TMT). Compare your TMT with your regular income tax. If the regular tax is higher, you don't owe any AMT. But if the regular tax is lower, the difference between the two taxes is the amount of AMT you must pay in addition to your regular tax (if any).

> ***Example 1:*** Your regular income tax is $47,000. When you calculate your tax using the AMT rules, you come up with $39,000. That's lower than the regular tax, so you don't pay any AMT.
>
> ***Example 2:*** Your regular income tax is $47,000. When you calculate your tax using the AMT rules, you come up with $58,000. You have to pay $11,000 of AMT on top of the $47,000 of regular income tax.

You must have noticed that the total amount of tax you pay in *Example 2* is equal to the tax calculated under the AMT: $58,000. But it's important to note that you actually pay $47,000 of regular tax plus $11,000 of AMT.

Calculation of AMT-An Overview:

Regular Taxable Income (+/-) Adjustments (+) Preferences
Alternative Minimum Taxable Income (AMTI) < Exemption >
Alternative Minimum Tax Base X Tax Computation
Tentative AMT Tax < Tax Credits >*
Tentative Minimum Tax (TMT) < Regular Income Tax >
Alternative Minimum Tax

** To be discussed in the next issue*

We will discuss some critical issues and planning tools pertaining to AMT in our next issue. Stay tuned...

Disclaimer:

The content of this article is based on tax legislation in operation at the time of publication, which may subsequently have changed. This article does not constitute tax or legal advice. Although we endeavor to provide accurate information, you should not act upon such information without appropriate professional advice after a thorough examination of your particular situation.

We appreciate and value your feedback very much. Let us know how we can help make this communication vehicle and the learning resource more valuable to you.

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Sincerely,

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