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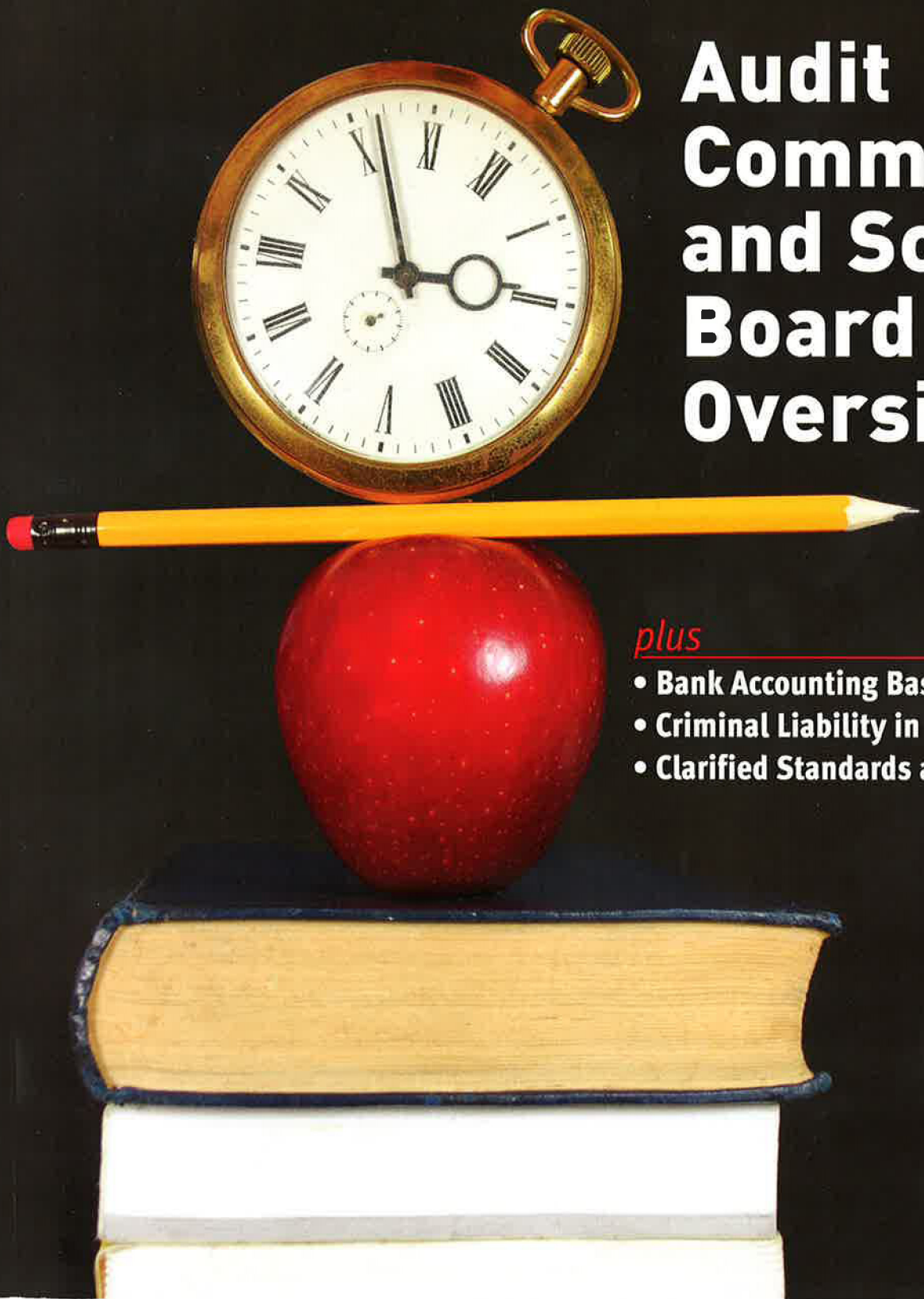

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Strategies for Reducing the Alternative Minimum Tax Liability

Considering the AMT's Design and the Effect of State Taxes

By Thomas Horan and Margaret Horan

The Alternative Minimum Tax (AMT) is imposed on taxpayers whose tax deductions and tax preference items reduce their taxable income below a specified level. When considering the AMT, it is important to examine the tax from several different perspectives. First, one must consider the original intent of the AMT, which was designed to tax wealthy individuals who could circumvent taxes by taking full advantage of tax loopholes. But it has become a tax that affects the middle class under certain circumstances.

Second, one should review the mechanics of the AMT; this discussion provides a specific example and a reflection upon how the AMT becomes operative as a replacement to the traditional tax, or regular tax. Third, one should remember that individual state taxes affect the AMT and that taxpayers in states with high

state taxes are more likely to be affected by the AMT than those in states with low state taxes. There are, however, some specific techniques for potentially reducing the AMT; planning strategies will vary greatly for taxpayers living in different states.

Overview of the AMT

The AMT was preceded by the Minimum Tax of 1969. Around that time, it came to Congress' attention from then–Secretary of the Treasury Joseph W. Barr that 155 people with adjusted taxable income of more than $200,000 had zero tax liability. Congress was flooded with mail from irate taxpayers demanding a resolution to this situation. According to Michael J. Graetz in *The U.S. Income Tax: What it is, How it Got That Way, and Where We Go from Here*, Congress received more mail on this item than on the raging Vietnam War.

Consequently, the Minimum Tax was established in order to prevent high-income taxpayers from avoiding taxation completely by limiting the use of tax loopholes. Over the intervening years, the basic tax changed somewhat, but it maintained its original purpose. The regular tax system imposes rates progressively higher for those with higher incomes, with a ceiling rate of 35% (revised to 39.6% in 2013 by the American Taxpayer Relief Act of 2012 [ATRA]), while the AMT provides a floor so that individuals proficient in tax law application cannot completely avoid paying taxes.

Originally, the AMT received little notice because it affected only a few taxpayers; however, during recent years, it has been slipping quietly into more tax returns. One reason why is that the AMT was not sufficiently indexed to inflation in the way that other items—such as personal exemptions and standard deductions—were. In addition, the AMT was functioning well as an unintended, but welcomed, generator of federal tax revenue. Research shows that taxpayers who are married filing jointly, have many children, and live in high-income-tax states are disproportionately affected by the AMT.

The good news is that the AMT exemption has been indexed to inflation starting for 2012, when President Obama signed the ATRA into law on January 1, 2013. The exemption amounts for unmarried taxpayers are $48,450 for 2011, $50,600 for 2012, and $51,900 for 2013 ($74,450, $78,750, and $80,800, respectively, for married taxpayers filing jointly).

AMT Case Study

When the AMT becomes operational, it replaces the traditional tax or regular tax. The following case study presents a scenario that explores the traditional tax and

EXHIBIT 1
Computation of Taxable Income: Married Filing Jointly

Income	
Salary	$175,000
Interest Income	$1,000
Dividends	$2,000
Short-Term Capital Gains	$10,000
Schedule C Income	$5,000
Exemptions	
Personal Exemptions (4 × $3,700)	$14,800
Itemized Deductions	
Medical	$5,000
Real Estate Taxes	$10,000
Mortgage Interest	$10,500
Charitable Contributions	$3,000
Misc. Itemized Deductions	$2,000
State Income Tax Deductions	$10,096

The following is the computation of taxable income:

Income			
Salary Income			$175,000
Schedule C Income			5,000
Interest Income			1,000
Adjustment for Social Security Tax			–353
Short Term Capital Gains			10,000
Total			$190,647
Less Deductions	Actual	Allowed	
Medical	5,000	0	
Real Estate Taxes	10,000	10,000	
Mortgage Interest	10,500	10,500	
Charitable Contributions	3,000	3,000	
Misc. Itemized Deductions	2,000	0	
State Income Taxes Paid	10,096	10,096	
Personal Exemptions (4 × $3,700)	14,800	14,800	
Less Total Deductions			48,396
Taxable Income			**$142,251**

EXHIBIT 2
Schedule Y-1, Married Filing Jointly or Qualifying Widow(er)

If taxable Income is…		The tax is…		…on the amount over
More than…	But not more than…			
$0	$17,000	—	10%	0
$17,000	$69,000	$1,700	15%	$17,000
$69,000	$139,350	$9,500	25%	$69,000
$139,350	$212,300	$27,087.50	28%	$139,350
$212,300	$379,150	$47,513.50	33%	$212,300
$379,150	—	$102,574.00	35%	$379,150

Source: Form 1040 Instructions, 2011, p. 98

The following is the total tax computation without consideration of the alternative minimum tax (AMT):

		Tax
Taxable income	$142,251	
Less: Appropriate Base	139,350	$27,088
Excess over Base	$2,901	
Applicable Tax Rate	0.28	812
Total tax on Regular Income		$27,900
Plus: 15% of $2,000 Qualified Dividends		300
Subtotal		$28,200
Plus: Medicare Tax Schedule C		614
Total Tax without AMT Consideration		$28,814

The following is the AMT tax computation:

Total Income (Including Dividends)	$192,647
Less: Allowable Deductions	
Mortgage Interest	10,500
Contributions	3,000
Alternative Minimum Taxable Income (AMTI)	$179,147
Less: Blanket Amount Reduced for Limitation	
179,147 – 150,000 = 29,147 × 25% = 7,287	
74,450 – 7,287 = 67,163	67,163
	$111,984
Less: Qualifying Dividends	2,000
Taxable Amount	$109,984
× 26%	$28,596
Plus: Medicare Tax Schedule C	614
Qualified Dividends ($2,000 × 15%)	300
Tax under AMT	$29,510
Tax without AMT	$28,814
Additional AMT Tax	$696

AMT, without the use of tax forms. A comprehensive understanding of the traditional tax structure is necessary to segue to the AMT tax structure and determine what triggers tax implications.

Assume the following facts for a married-filing-jointly couple with two dependent children for the 2011 tax year. Both individuals reside in Connecticut, and their state income taxes equal their state tax liability. (See *Exhibit 1* for a computation of the couple's taxable income).

A tax is computed from the appropriate schedule table (*Exhibit 2*) and is added to the tax on qualified dividends at 15% and to the Medicare tax in order to arrive at the regular tax. Note that the mortgage interest deduction remains the same for both the regular and the AMT calculations. First, the taxpayers compute their regular tax liability the usual way—all taxable income minus deductions and personal exemptions and other applicable items. The regular tax is determined by function of the appropriate tax schedule.

As a second step, the AMT is computed, and the larger of the two is the amount owed; in this case study, the AMT replaces the regular tax. In a simplified discussion, the AMT is essentially more direct and is akin to a flat tax. It does not allow for specific deductions, such as state income taxes, real estate taxes, miscellaneous deductions, some medical expenses, personal exemptions, or other tax preference items. It allows a blanket exemption for these items—for 2011, this is $48,450 for single filers and $74,450 for those who are married filing jointly. This blanket amount is reduced by 25% when Alternative Minimum Taxable Income (AMTI) exceeds $112,500 ($150,000 for those married filing jointly). The AMTI is the taxable income minus the itemized deductions allowable under the AMT (in this scenario, contributions and mortgage interest). Thus, the blanket amount of $74,450 is completely lost when AMTI is $306,300 ([$48,450 × 4] + $112,500) or more for single filers and $447,800 ([$74,450 × 4] + 150,000) or more for married filing jointly. The AMT is 26% for the first $175,000 of AMTI over the blanket amount, and the amount above that is taxed at 28%.

If this generates a tax that is higher than the regular tax, the difference between the two is labeled as the AMT tax. It is likely that income in excess of $250,000

will not be subject to the AMT but will be subject to the higher tax under Schedules XYZ, because the progressive rates are 10%, 15%, 25%, 28%, 33%, and 35% for several layers of income. Also operative, if applicable, are the separate computations of the 15% tax on qualified dividends and long-term capital gains, along with Social Security taxes.

The Effect of State Taxes

The same information for the above case study was calculated again on both the federal level and the state level (for 26 states—Alabama, Alaska, Arizona, California, Colorado, Connecticut, Delaware, Florida, Hawaii, Illinois, Kansas, Massachusetts, Michigan, Nevada, North Carolina, New Hampshire, New Jersey, New Mexico, New York, Ohio, Oregon, Pennsylvania, South Carolina, Texas, Utah, and Wyoming). This analysis computed New York taxes twice, once for New York State residents, and then again for New York State residents who are also New York City residents. In the other states, only the state income tax was considered—even if municipalities impose an income tax—and sales taxes were ignored.

In each case, it was presumed that the full state income tax imposed was paid by December 31 in order to take advantage of the deduction on Schedule A; actually, the AMT allows a generous blanket exemption, plus additional deduction for charity and mortgage interest. Thus, medical, real estate taxes, miscellaneous deductions, personal exemptions, and other amounts are allowed to the extent of the AMT blanket exemption. The AMT is affected by the state income tax, which varies from state to state, and the real estate tax, which in this example was assumed to be at $10,000. In this scenario, the AMT is triggered primarily by state income taxes; however, medical expenses or other tax preference items might act as the trigger in other scenarios. The findings are summarized in *Exhibit 3*.

For 15 of the 27 cases examined—California, Connecticut, Delaware, Hawaii, Illinois, Kansas, Massachusetts, Michigan, New York, New York State with New York City, North Carolina, Ohio, Oregon, South Carolina, Utah—the AMT was a factor in federal taxes. The amount of the AMT ranged from a low of $45 for Michigan residents to a high of $2,593 for New York State and New York City residents. The AMT is operating as a floor to federal taxes.

It is not surprising that residents of states that do not have a state income tax are not subject to the federal AMT. It is also interesting that all six of the states with no state income tax paid the highest federal income tax ($31,027), plus Social Security tax ($614), for a total of $31,641. The states in this sample that have no state income tax are Alaska, Florida, Nevada, New Hampshire, Texas, and Wyoming; when considering the entire country, nine states (including South Dakota, Tennessee, and Washington) have no state income tax. As previously mentioned, New York State and New York City residents had the highest AMT ($2,593), followed by Oregon ($1,644), North Carolina ($1,097), New York State ($1,075), Hawaii ($1,031), and Massachusetts ($921). Not surprisingly, these are also the governments with the highest total tax—$46,845; $43,048; $41,036; $40,960; $40,715; and $40,409, respectively. Thus, state taxes will reduce the federal income tax burden at least somewhat, because they might not be totally eliminated through the AMT system.

This case study illustrates that total tax liability is a function of state income taxes, which can affect the AMT. Because those states with the highest income taxes have the highest AMT, it implies that the mechanics of the AMT eliminate much of the utility of the deduction for state income taxes.

Planning Considerations

Because the AMT affects more and more middle-income taxpayers, the expertise of a tax advisor knowledgeable in this area is a necessity. Taxpayers on the brink of paying the AMT can benefit the most from such advice; this is the point where a taxpayer gets full benefit of the deductions before being penalized by the AMT. The key is to determine the individual combination of income and deductions that will enable a taxpayer to stay at the top end of the traditional tax.

First, it is necessary to assess the consequence of the AMT in the prior year and then adjust for current-year projections in order to determine the predicted impact of the AMT. If a taxpayer's regular marginal tax bracket (28% in the earlier case study) is greater than the applicable 26% or 28% of the AMT (26% in the study), unused deductions should be shifted back to a year without the AMT. In this study, the AMT represents approximately $2,486 in lost deductions; this amount is used loosely as a starting point because the AMT creates a ripple effect on taxable income and the blanket amount by differing, nonlinear values. The strategy is to increase income, decrease deductions, or some combination of both, by this amount. Increasing year-end income might seem counterintuitive to the traditional taxpayer, but in the case of those vulnerable to the AMT, it might increase the traditional tax enough to avoid the AMT. Year-end bonuses, deferred annuities, and short-term capital gains are a few items to consider. The deductions should either be decreased through deferral or bypassed.

For example, there is no tax rationale for accelerating real estate tax payments, which

are not deductible. In the case of excessive or estimated state income tax payments, one should consider reducing, eliminating, or deferring to the next tax year. It is important to note that long-term capital gains taxed at 15% will not make a difference, because this income item is taxed at the same rate under both structures. Taxpayers and their advisors should consider the following additional planning strategies.

EXHIBIT 3
Tabulation of State Income Taxes, Regular Federal Taxes, the Alternative Minimum Tax (AMT), and Total Taxes

	State Tax	Regular Federal Tax	AMT	Total Federal Tax	Combined Taxes
Alaska	$0	$31,641	$0	$31,641	$31,641
Florida	$0	$31,641	$0	$31,641	$31,641
Nevada	$0	$31,641	$0	$31,641	$31,641
New Hampshire	$0	$31,641	$0	$31,641	$31,641
Texas	$0	$31,641	$0	$31,641	$31,641
Wyoming	$0	$31,641	$0	$31,641	$31,641
Arizona	$5,547	$30,088	$0	$30,088	$35,635
Pennsylvania	$5,925	$29,982	$0	$29,982	$35,907
Alabama	$6,941	$29,697	$0	$29,697	$36,638
Colorado	$7,146	$29,640	$0	$29,640	$36,786
New Mexico	$7,155	$29,637	$0	$29,637	$36,792
New Jersey	$7,542	$29,529	$0	$29,529	$37,071
Michigan	$7,769	$29,465	$45	$29,510	$37,279
Ohio	$8,291	$29,319	$191	$29,510	$37,801
Illinois	$8,732	$29,195	$315	$29,510	$38,242
Kansas	$9,384	$29,013	$497	$29,510	$38,894
Utah	$9,632	$28,944	$566	$29,510	$39,142
Delaware	$10,089	$28,815	$695	$29,510	$39,599
Connecticut	$10,096	$28,814	$696	$29,510	$39,606
South Carolina	$10,335	$28,747	$763	$29,510	$39,845
California	$10,192	$28,787	$723	$29,510	$39,702
Massachusetts	$10,899	$28,589	$921	$29,510	$40,409
Hawaii	$11,292	$28,479	$1,031	$29,510	$40,715
New York State	$11,450	$28,435	$1,075	$29,510	$40,960
North Carolina	$11,526	$28,413	$1,097	$29,510	$41,036
Oregon	$13,538	$27,866	$1,644	$29,510	$43,048
New York State and New York City	$17,335	$26,917	$2,593	$29,510	$46,845

Dependents. Taxpayers with college-age dependents should examine whether those dependents can qualify to take themselves as a personal exemption. If so, taxpayers should forego the exemption; however, they must take into consideration that the lost exemption might result in an increased state income tax.

Deductions. Taxpayers should consider foregoing deductions entirely if they do not reduce their tax liability; this makes the return cleaner and less auditable. Again, taxpayers must exercise caution because not taking a deduction on the federal level could preclude taking the deduction on the state level.

Real estate taxes and mortgage interest. One strategy for unutilized real estate taxes and mortgage interest is to determine whether they can be moved from Schedule A to Schedule C or Schedule E. Is it possible to generate an income activity to earmark for these deductions? Many an equity line of credit has been taken out to purchase a second home, thus generating real estate taxes and mortgage interest to deduct. Taxpayers with a second home should consider renting it out and then reporting the income on Schedule E, along with the corresponding real estate taxes and mortgage interest.

Similarly, taxpayers should think of possible ways to generate income that can be reported on Schedule C. Can an office meet the IRS's requirements to be considered a home office? If so, the corresponding real estate taxes and mortgage interest from the equity line of credit can be proportionally taken by the used office space. In addition, any corresponding itemized professional fees can be moved to this schedule. It is important to remember that if a taxpayer's income surpasses $110,100 in 2012, additional Social Security taxes do not apply to any income in excess of this limit.

Charitable contributions. There is no need to reduce charitable contributions; they are allowed as a separate freestanding item on the AMT. Increasing a charitable deduction will reduce taxable income.

Relocation. It is probably not practical for most taxpayers, but those who can relocate should note the expense of state income taxes and its effect on the AMT (shown in Exhibit 3). For example, a

New York City resident will notice that the neighboring states of Pennsylvania and New Jersey have much lower taxes; relocating to those states might be an idea worth considering.

Additional Strategies

If it is not possible for a taxpayer to avoid an AMT liability, other options are available. First, municipal bond investors might want to consider investing in general-obligation bonds rather than private-activity bonds, which are subject to the AMT. Most mutual funds are cognizant of this problem and offer options that avoid investing in private activities. Some of the larger funds that offer this alternative are USAA tax-exempt bond funds, Fidelity AMT tax-free municipal bond funds, American Funds tax-exempt bond funds, and the iShares S&P National Municipal Bond Fund ETF.

Second, taxpayers should remain alert to retirement investments by maximizing contributions to individual retirement accounts (IRA), 401(k) plans, or simplified employee pension plans (SEP). Contributions to these accounts reduce taxpayers' gross taxable income. Another alternative would include taking advantage of pretax health savings plans and transportation plans offered by employers.

Third, taxpayers should have an understanding of different stock options, such as nonqualified stock options (NSO) and incentive stock options (ISO). Upon exercising an ISO, the spread between the grant price and the purchase price is subject to the AMT. In situations where ISOs come into play, a tax professional familiar with them is crucial.

Building Awareness

Taxpayers subject to the AMT might not know that traditional deductions and personal exemptions do not fully reduce tax their liability. Another significant factor is that one's tax liability differs depending upon the domicile state. Personalized planning strategies can help even those affected by the AMT exercise control of their tax liability. No one is required to pay more taxes than required by the tax law, and planning is a year-round activity necessary to avoid tax overpayment. Most taxpayers are glad not to be subject to the AMT because of the lower rates under the traditional schedules. At a certain point, however, it is better for high-income individuals; in such cases, exclusion would result in a return to the traditional tax rate schedules, which have higher marginal and average tax rates at higher levels of income. ❑

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