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ALTERNATIVE MINIMUM TAX (AMT)

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Background

There are two types of income tax – **regular** tax that you are familiar with, and an **Alternative Minimum Tax (AMT)** that remains a mystery to most taxpayers. What is this **AMT** that has silently crept into your pocket book? AMT is a separate tax that was originally drafted in 1969 to make sure that wealthy individuals with tax shelters paid their fair share of taxes. Unfortunately, it has not worked that way. AMT has snared more and more taxpayers like you and me. This AMT burns unsuspecting taxpayers who have second mortgages, high state income tax, high property tax bills, or several dependents. Taxpayer-friendly tax acts over the last few years and inflation-adjustment mechanisms have lowered regular taxes. Unfortunately, AMT lacks the inflation adjustment mechanism and has not received as many reduction provisions as regular income tax. What we have been getting is a series of temporary patches to provide some minor relief from AMT.

How AMT Works

AMT is a separate system that adds back what you deduct for regular income tax. The most common adjustments and preferences that result in **add-backs** (and higher taxes) are:

1. Personal and dependent **exemption** deductions.
2. **Standard deduction** for those who don't itemize.
3. Deduction for state, local, and foreign income, sales, and property **taxes**.
4. **Home equity loan interest** when loan proceeds are not used for home improvements.
5. Medical expenses not in excess of 10% of AGI.
6. **Miscellaneous itemized deductions** subject to the 2% of AGI floor (such as tax professional fees, investment expenses, and employee business expenses).
7. Interest income from private activity bonds.
8. The difference between AMT and regular tax depreciation.
9. The spread between market value and exercise price for incentive stock options.

How to Avoid AMT

Unfortunately, it's difficult to "plan around" AMT because applicable Code Sections were cleverly drafted to prevent moves to reduce your AMT. But we still have a **few tips to reduce your AMT**:

1. AMT is AGI-driven. Take action to **reduce your Adjusted Gross Income (AGI)**. A lower AGI reduces your state and local income tax bills, which further reduces your AMT exposure. It also qualifies you for other breaks that reduce both of your regular tax and AMT liabilities.
2. **Trigger deductible capital losses** by selling stocks and investments that have gone down in value.
3. If you are already in an AMT mode that does not generate minimum tax credits, accelerate ordinary income into this year or postpone deductions to next year. For example, **accelerate collections of cash-basis business receivables and defer cash-basis deductible expenditures**. Go against conventional tax plans by accelerating ordinary income to the point where this year's regular tax and AMT liabilities are equalized.

Beware Of Tax Plan Tips That Work For Regular Income Tax But Not For AMT

Here are some conventional year-end tips that may reduce your regular income tax but may **backfire for AMT**:

1. **Do not prepay state and local income and property taxes before year-end**. Prepayment generates a bigger regular tax write-off, but the deduction is completely disallowed in computing alternative minimum taxable income. Prepaying in 2010 could turn an expense that could otherwise be deducted in 2011 into an expense that will not generate any tax benefit whatsoever. (Accelerating qualified home mortgage payments and charitable contributions is alright because these expenses are deductible for both AMT and regular tax).
2. **Do not use home equity loan proceeds to pay off debts that generate nondeductible personal interest** such as credit card balances. For AMT purposes, home equity loans generate deductible interest only to the extent that

proceeds are used to buy, build, or substantially improve your first or second residence. It's also deductible if you take a home equity loan to refinance another loan that was used for such expenditures.

Developments

AMT exemption amounts for tax years beginning in 2011 increase to \$48,450 for unmarried individuals, \$74,450 for married individuals filing jointly, and \$37,225 for married individuals filing separately.