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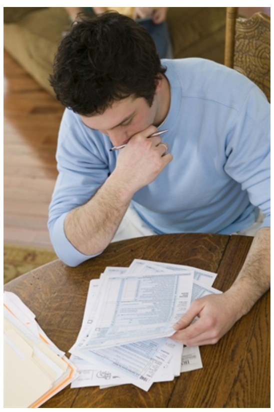
The Alternative Minimum Tax (AMT)



In the past ten years there have been eight temporary legislative AMT-related "patches," designed to forestall a sudden dramatic increase in the number of individuals who are affected by the AMT. The latest two-year patch, included as part of the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010, is effective through December 31, 2011. That means you can expect additional AMT legislation later this year or in early 2012.

What is the AMT?

The AMT is essentially a separate federal income tax system with its own tax rates, and its own set of rules governing the recognition and timing of income and expenses. If you're subject to the AMT, you have to calculate your taxes twice--once under the regular tax system and again under the AMT system. If your income tax liability under the AMT is greater than your liability under the regular tax system, the difference is reported as an additional tax on your federal income tax return. If you're subject to the AMT in one year, you may be entitled to a credit that can be applied against regular tax liability in future years.

How do you know if you're subject to the AMT?

Part of the problem with the AMT is that, without doing some calculations, there's no easy way to determine whether or not you're subject to the tax. Key AMT "triggers" include the number of personal exemptions you claim, your miscellaneous itemized deductions, and your state and local tax deductions. So, for example, if you have a large family and live in a high-tax state, there's a good possibility you might have to contend with the AMT. IRS Form 1040 instructions include a worksheet that may help you determine whether you're subject to the AMT (an electronic version of this worksheet is also available on the IRS website), but you might need to complete IRS Form 6251 to know for sure.

Common AMT adjustments

It's no easy task to calculate the AMT, in part because of the number and seemingly disparate nature of the adjustments that need to be made. Here are some of the more common AMT adjustments:

- Standard deduction and personal exemptions: The federal standard deduction, generally available under the regular tax system if you don't itemize deductions, is not allowed for purposes of calculating the AMT. Nor can you take a deduction for personal exemptions.
- Itemized deductions: Under the AMT calculation, no deduction is allowed for state and local taxes paid, or for certain miscellaneous itemized deductions. Your deduction for medical expenses may also be reduced, and you can only deduct qualifying residence interest (e.g., mortgage or home equity loan interest) to the extent the loan proceeds are used to purchase, construct, or improve a principal residence.
- Exercise of incentive stock options (ISOs): Under the regular tax system, tax is generally deferred until you sell the acquired stock. But for AMT purposes, when you exercise an ISO, income is generally recognized to the extent that the fair market value of the acquired shares exceeds the option price. This means that a significant ISO exercise in a year can trigger AMT liability. If ISOs are exercised and sold in the same year, however, no AMT adjustment is needed, since any income would be recognized for regular tax purposes as well.
- Depreciation: If you're depreciating assets (for example, if you're a sole proprietor and own an asset for business use), you'll have to calculate depreciation twice--once under regular income tax rules and once under AMT rules.

AMT exemption amounts

While the AMT takes away personal exemptions and a number of deductions, it provides specific AMT exemptions. The amount of AMT exemption that you're entitled to depends on your filing status.

AMT Exemption Amounts by Filing Status	2011	2012
Married filing jointly	$74,450	$45,000
Single or head of household	$48,450	$33,750
Married filing separately	$37,225	$22,500

Note: *The 2012 figures assume no additional Congressional action.*

Your exemption amount, however, begins to phase out once your taxable income exceeds a certain threshold ($150,000 for married individuals filing jointly, $112,500 for single individuals, and $75,000 for married individuals filing separately).

What happens in 2012?

AMT exemption amounts and phaseout thresholds are not adjusted for inflation--they only change through legislation. This is one of the principal reasons that more people tend to be subject to the AMT each year. The increased AMT exemption amounts included in the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 are for the 2010 and 2011 tax years only. Unless Congress passes new legislation, 2012 AMT exemption amounts will return to pre-2001 levels. In addition, without new legislation, the AMT rules could limit your ability to claim certain nonrefundable personal tax credits in 2012, including the American Opportunity (Hope) and Lifetime Learning tax credits, the dependent care credit, and the credit for the elderly and disabled.

AMT rates

Under the AMT, the first $175,000 of your taxable income is taxed at a rate of 26%. (If your filing status is married filing separately, the 26% rate applies to your first $87,500 in taxable income.) Taxable income above this amount is taxed at a flat rate of 28%.

The lower maximum tax rates that apply to long-term capital gain and qualifying dividends apply to the AMT calculation as well. So, even under AMT rules, a maximum rate of 15% (0% for individuals in the lower two tax brackets) applies. However, long-term capital gain and qualifying dividends are included when you determine your taxable income under the AMT system. That means large capital gains and qualifying dividends can push you into the phaseout range for AMT exemptions, and can indirectly increase AMT exposure.

Technical Note: *In the context of AMT exemption amounts and tax rates, taxable income really refers to your alternative minimum taxable income (AMTI). Your AMTI is your regular taxable income increased or decreased by AMT preferences and adjustments.*

Summing up

Owing AMT isn't the end of the world, but it can be a very unpleasant surprise. It also turns a number of traditional tax planning strategies (e.g., accelerating deductions) on their heads, so it's a good idea to factor in the AMT before the end of the year, while there's still time to plan.

If you think you might be subject to the AMT, it may be worth sitting down to discuss your situation with a tax professional.