Surprised by the Alternative Minimum Tax?

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When looking over your tax return, do you notice an amount on line 45? If an amount is entered there, it is because you are subject to the alternative minimum tax (AMT). The AMT is a generally punitive method of computing income tax that does not allow some of the tax preferences and deductions that regular tax computation allows. When an AMT computation results in a higher tax, the higher tax applies, and the additional tax from the AMT is added on line 45 of your return.

The AMT was originally designed (nearly 50 years ago) to impose a minimum tax on higher-income taxpayers who were avoiding taxes by claiming certain (legal) deductions or other tax benefits (also termed "preferences"). However, years of inflation have caused an increasing number of taxpayers to be subject to the AMT.

It is complicated to determine when an individual will be subject to the AMT, for many tax preferences can trigger the AMT, alone or in combination. The following are some of the items that frequently trigger the AMT for the average taxpayer:

- **Medical Deductions** – Deductions for medical expenses are allowed for the AMT computation – but only to the extent that they exceed 10% of the taxpayer's income. Although the limit is also 10% for regular tax purposes, through 2016, taxpayers age 65 and over enjoy a lower limit of 7.5%, which leads to an AMT adjustment. Sometimes, it is possible to defer or accelerate medical expenses from one year to another (for example, by paying an orthodontist in installments or all at once). If your employer offers a flexible spending plan, consider participating, as such plans allow you to pay medical expenses with pretax dollars while avoiding both regular and AMT deduction limitations.

- **Deduction for Taxes Paid** – When itemizing deductions, a taxpayer is allowed to deduct a variety of other taxes, such as real or personal property taxes and state income or sales taxes. However, for AMT purposes, none of these itemized taxes is deductible. For most taxpayers, this represents one of the largest tax deductions, and it frequently triggers the AMT. If you are affected by the AMT, conventional wisdom dictates deferring tax payments to a subsequent year when the AMT may not apply. When deferring, care should be exercised regarding late-payment penalties and interest on underpayments. In addition, taxpayers can annually elect to capitalize their taxes on unimproved and unproductive real estate. This means foregoing the deduction and adding the tax paid to the cost basis of the real property.

- **Home Mortgage Interest** – For both regular tax and AMT computations, interest paid on a debt to acquire or substantially improve a first or second home is deductible as long as it does not exceed the debt limit (generally $1 million). This is also true of refinanced debt, except that any increase in debt is treated as equity debt. For regular tax purposes, the interest on up to $100,000 of equity debt on the first two homes can also be deducted. However, equity debt is not deductible when computing the AMT; neither is acquisition or equity debt on a motor home or boat that may qualify as a second home. Therefore, taxpayers should exercise caution when incurring home equity debt. Generally, loan brokers are not aware of these limitations, and there are numerous pitfalls.

- **Miscellaneous Itemized Deductions** – Among miscellaneous deductions, the category that includes employee business and investment expenses is not deductible for AMT purposes. For certain taxpayers with deductible employee business expenses, this will often trigger the AMT. Employees with significant employee business expenses should attempt to negotiate an "accountable" reimbursement plan with their employers. Under this type of plan, reimbursement for qualified expenses is tax-free. An employee who has been reimbursed no longer claims a deduction for those expenses, thus eliminating the miscellaneous deduction. Another strategy would be to defer the expenses to a year that is not affected by the AMT.
- **Personal Exemptions** – The AMT computation does not allow a deduction for personal exemptions, which in 2016 is $4,050 each for the taxpayer, his or her spouse (if any) and any dependents. Divorced or separated parents should carefully consider which party should claim the exemption for their children if one of the parents is subject to the AMT.
- **Standard Deduction** – For regular tax purposes, taxpayers have the option of itemizing their deductions or taking the standard deduction. However, for AMT purposes, there is no standard deduction. Thus, a taxpayer who ends up with an AMT when taking the standard deduction should try to force itemized deductions, even if the result is less than the standard deduction. The result will be an increased regular tax but a reduced AMT, which could result in overall tax savings. Even the smallest of deductions will benefit those who are taxed at a minimum of 26% (the lowest bracket for the AMT).
- **Incentive Stock Options** – Although not frequently encountered, incentive stock options (ISOs) can have a profound impact on a taxpayer's AMT. Generally, to achieve the beneficial long-term capital gains rates on stock acquired through an ISO, a taxpayer must hold the stock for more than one year after exercising the stock option and two years after the option is granted. However, the difference between the fair market value and the option price must be added to the taxpayer's AMT income in the year the option is exercised. To avoid this substantial AMT preference income, the taxpayer can sell the stock in the year that the option is exercised and forego long-term capital gains rates. Alternatively, when doing so is beneficial, the taxpayer can exercise the option in small blocks over a period of years.
- **Business Incentives** – Taxpayers' investments in businesses and partnerships sometimes provide tax incentives that the AMT does not allow. There is a long list of these incentives, but the most common are depletion allowances and intangible drill costs. Generally, these items appear on a Schedule K-1 (which the business activity issues to the investor) and are then included in the taxpayer's AMT calculation.

As you can see, the AMT can be an extremely complicated area of tax law. Careful planning is required to minimize its effects. Please contact our office for further assistance.