

Q & A: Understanding the AMT

What, exactly, is the AMT?

The AMT began life in 1969 as a response to the discovery that certain wealthy taxpayers were legally paying little or no federal income tax.

Originally, the AMT took aim at taxpayers who used—or abused—certain tax shelters, referred to as “tax preferences,” and other adjustments to their income to reduce substantially, or eliminate entirely, their income tax liability. Over the years there has been constant tinkering that has broadened the scope of the tax and increased the number of taxpayers who must pay it.

How does the AMT work?

Generally, preferences and adjustments are added back to your regular taxable income to arrive at your AMT income. Then an AMT exemption is subtracted. What’s left is subject to a 26% tentative minimum tax on the first \$175,000 and a 28% tax on the excess. The amount, if any, by which that tentative minimum tax exceeds ordinary income tax is your AMT liability. The exemption for 2007 is currently \$33,750 for single filers, \$45,000 for married couples filing jointly or a widow(er) and \$22,500 for marrieds filing separately.

These amounts are less than the exemptions available in recent years when inflation adjustments were in place. Although Congress extended the higher exemption amounts for last year, no action has been taken yet for a 2007 extension.

What are some of these preferences?

- Personal and dependent exemptions.
- State and local taxes.
- A portion of the deduction for medical expenses.

- Most miscellaneous expenses.
- The standard deduction, if claimed.
- The “bargain element” of incentive stock options—the spread between the price paid for the stock and the market price when the option is exercised.
- Interest on mortgages and home equity loans that were not used to build, buy or improve a “qualifying” residence.
- Income from municipal bonds issued to finance “private activities” such as sports stadiums.

An examination of the AMT by the American Bar Association looked at the effect of these preferences and drew some troubling conclusions. For instance, with the personal and dependent exemptions on the list, large families may come within the scope of the AMT. The same is true for residents of states with high income and property taxes.

What’s the likelihood of having to pay the AMT?

If you had substantial earnings and made use of several AMT preferences, you well may be liable for the tax. There’s really no easy way to tell. The point is, if there’s any chance that you might be liable for the AMT, you have to run the numbers. If the IRS finds an AMT liability that you didn’t report, you will own the AMT, along with interest and penalties.

Are there ways to avoid the AMT?

It’s a good idea to assess the likelihood that you will fall in AMT territory before the end of your tax year, so that you may take steps to reduce or eliminate your exposure. To escape the AMT, you may want to consult with your tax advisor to consider exactly what you can do, if anything, to avoid it. On the other

hand, if paying the AMT is inevitable, and you are a taxpayer who is in the 33% or 35% bracket, it would be to your benefit to take advantage of the lower 26% and 28% AMT rates rather than the higher ordinary income tax rates.

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