THE ALTERNATIVE MINIMUM TAX

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This is one of a series of Research Briefs created by Brinton Eaton to keep our clients informed about key developments — in financial planning, tax strategy, and investment management — that we research and implement as appropriate on your behalf.

In 1968, the IRS advised Congress that 155 individuals who earned more than $200,000 in 1966 paid zero income tax. Congress reacted a year later by creating the Alternative Minimum Tax (AMT) to ensure that all taxpayers pay at least some income tax.

To put this in current perspective, a taxpayer earning $200,000 annually in 1966 who received 4% annual raises would have earned roughly $1,080,000 in 2009. The group earning more than this is obviously a small minority of taxpayers. So why all the press coverage (*Newsweek, Time, The New York Times, Business Week, Barron's*, etc., etc.) on the AMT? The reason is that almost 4,000,000 taxpayers (not 155) were caught in the AMT web in 2009, and the majority of those caught earned only between $75,000 and $300,000 (not $1,080,000 or more). Barring dramatic changes, it is estimated that three out of every five taxpayers earning over $75,000 will be in the AMT by 2010.

It is important to understand that the AMT is a tax paid in lieu of your regular income tax. The AMT operates parallel to the regular tax and has its own set of rates, rules, and tax brackets, which generally are not affected by changes in the "regular" tax code. In fact, the recent tax changes offered little relief to those already in the AMT.

Simply stated, the AMT taxes certain income not subject to regular taxation, such as the "phantom income" generated by Incentive Stock Options (ISOs)[*], and disallows many deductions and exemptions, the most significant of which are real estate taxes, state income taxes, miscellaneous deductions, and exemptions for dependents. In place of these deductions/exemptions there is an AMT exemption amount, which is not tied to inflation. Congress has periodically raised the exemption amounts, but not fast enough to keep up with inflation. Worse, the exemption is phased out at higher incomes, and thus many taxpayers lose this exemption as their incomes rise over time.

To the extent that the culprit is the phantom income from the exercise of ISOs, there is at least the possibility of recouping AMT through an AMT credit when the stock is sold. This is not so for the loss of deductions/ exemptions — there is no AMT credit in these cases.

Unfortunately, if you live and/or work in states that have high income taxes or property taxes, such as New York, New Jersey, or California, there is little you can do to minimize the AMT unless you can control the timing of your income and deductions. This may work for self-employed taxpayers, but offers very little hope for those employed by corporations.

[*] When ISOs are exercised, the ISO holder is liable for AMT on the difference between the market price and the exercise price of the underlying stock. If the stock thus received is held (through at least the end of the tax year), the taxpayer is subject to tax on "income" he/she did not receive.

The example below highlights the ability of the AMT to trap taxpayers, at different levels of income, who live in states, such as New York, with high income taxes and high property taxes. If we calculate the 2009 federal income tax for three married couples with two children who have similar itemized deductions, and the only difference in their income is the amount of their wages, the results would be as follows:

	Couple #1	Couple #2	Couple #3
Wages	$150,000	$250,000	$350,000
Interest & Dividends	2,000	2,000	2,000
Net Medical Expenses	(3,600)	0	0
Charitable Contributions	(500)	(500)	(500)
Property Tax	(18,000)	(18,000)	(18,000)
NY State Income Tax	(12,000)	(23,000)	(37,000)
Mortgage Interest	(20,000)	(20,000)	(20,000)
Itemized Deductions, disallowed	0	852	1,852
Personal Exemptions, allowed	(7,300)	(7,251)	(5,305)
Taxable Income	**$90,600**	**$184,101**	**$273,047**
Regular Tax	14,271	39,812	67,927
AMT	712	7,347	14,232
Total Federal Tax	**$14,983**	**$47,159**	**$82,159**

Clearly, the AMT has gone well beyond its original purpose and, left unchecked, will soon become a more important revenue generator for the government than the regular tax. At a minimum, the AMT has a severe dampening impact on the economic stimuli that recent changes to the regular tax code were meant to provide.

The real fix to the AMT problem is repeal, or at least some form of inflation-indexing. Congress is not offering any solutions, and the presidential candidates are not eager to enter this quagmire. It is felt by most observers that no action will take place unless taxpayers join together and make it a priority issue.

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