THE NEED TO REFORM OR ELIMINATE THE INDIVIDUAL ALTERNATIVE MINIMUM TAX

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Abstract: The AMT is the single most serious problem with the Tax Code. This article discusses some of the problems with the AMT, its computations, and the tax planning related to it. Total repeal of the individual AMT would be an alternative that should be considered so that taxpayers would not be subject to the AMT when it was not originally the intention of the Congress to subject many of these taxpayers to the AMT.

INTRODUCTION

The individual Alternative Minimum Tax (AMT) has been a part of the U.S. tax system since the Tax Reform Act of 1969 and was enacted effective for 1970. It came about as a result of a report that 155 taxpayers with income of over $200,000 paid no federal income taxes.[1] The AMT started out as an add-on minimum tax equal to 10% of the tax preferences in excess of $30,000 plus the taxpayer's regular tax liability and certain carryovers. The rate was increased to 15% and the exemption was decreased in 1976. Further changes took place in 1978, 1982, 1986, 1990, and 1993.

From 1979 to 1982, the tax added the possibility of an alternative minimum tax and so taxpayers paid the larger of the add-on tax or the AMT. In 1983, the add-on part of the AMT was repealed and taxpayers began paying the AMT only if the tentative alternative minimum tax was larger than the regular tax. Over the years, the rates of the AMT increased from 21% in 1990 to 24% in 1991, and then increased to the present 26% and 28% with the 1993 Act. Starting in 2003, the AMT tax allowed capital gains and qualified dividends to be taxed at the capital gains rate to give the advantages present with the regular tax computation. At the end of virtually every year, Congress makes small patches in the AMT relating to exemptions or relatively minor points.

In 2006, the IRS's National Taxpayer Advocate's report highlighted that the AMT is the single most serious problem with the Tax Code.[2] In addition, one of the conclusions of the latter report was that the AMT leads to situations where most taxpayers who owe the AMT do not realize it until preparing their returns or being notified by the IRS. The AMT does not just hit the high income taxpayers. In 2008, a total of 27 percent of the households that paid the AMT had adjusted gross income of $200,000 or less.[3] Nearly every time individual tax reform is proposed, the AMT is mentioned as an area of concern; yet, little reform has been accomplished because there is always the revenue concern. The AMT raised $26 billion of the $1,031 billion total individual income tax in 2008.[4]

This article discusses some of the problems with the AMT, its computations, and the tax planning related to it; the major components causing an AMT liability; alternative proposals for dealing with this difficult area; and recommendations for tax reform in this area. Although there

[1] Pub. L. No. 91-272, 83 Stat. 487 (Dec. 30, 1969).
[2] National Taxpayer Advocate 2006 Annual Report to Congress.
[3] IRS 2010 Fall Statistics on Income Bulletin, p. 53.
[4] Id., p. 49.

have been proposals for AMT reform over the years,[5] the present article discusses the reasons that the AMT is so frustrating and difficult for taxpayers, all of which leads logically to a call for immediate major reform or repeal.

PROBLEMS WITH THE AMT

The calculation of the AMT is incredibly complicated with an assortment of adjustments and tax preferences and is virtually impossible to calculate by hand. The AMT Form 6251 is 54 lines long and the instructions for that form are a very detailed 14 pages long. For those taxpayers using computerized tax software, the calculation of the AMT might not cause any significant computational problems, but many taxpayers still do not know what caused them to be hit by the AMT. The number of households that pay the tax has increased significantly in the last 10-15 years. In 1997, for example, 605,000 taxpayers paid the AMT; by 2008, the number of affected taxpayers jumped to 3.9 million, or about 4% of individual taxpayers.[6] The Congressional Budget Office projects that unless Congress acts, the AMT would affect nearly half of all households by 2035.[7] This was certainly not the intention of those who enacted the law originally.

For years, Congress has passed one-year patches aimed at minimizing the impact of the tax. For the 2010 tax year, a patch was passed on December 16, 2010, but only after the IRS had already designed its forms for 2010. The IRS had to reprogram its forms to accommodate the law change.

The AMT is aimed at people who live in high tax states, own homes, and have children. Taxpayers who live in states with high income tax rates are up to seven times more likely to pay the AMT than those who live in states with lower income taxes. Taxpayers with large families—specifically families with three or more children—are more likely to pay the AMT than smaller families.[8]

In summary, in computing the AMT, taxpayers first add (or subtract) adjustment and add tax preferences to arrive at Alternative Minimum Taxable Income (AMTI). They then must subtract an exemption (which can be phased out) resulting in a net AMTI, and compute the tentative minimum tax applying a 26% rate on the first $175,000 of AMTI and 28% on the amount of AMTI in excess of $175,000. If this tentative minimum tax is larger than the regular tax, the excess is the amount of AMT owed. In addition, qualified dividends that are taxed at a maximum rate of 15% and capital gains that are taxed at a maximum rate of 15% or 25% for regular tax purposes are taxed at those rates for AMT purposes. The foreign tax credit and nonrefundable personal credits are allowed against the tax in determining the tentative minimum tax. Extra work may be necessary in computing AMT carryforwards which might be different from regular tax carryforwards. If taxpayers qualify for the AMT, further calculations could be necessary to compute AMT versions of carryforward losses and credits until used up in future years.

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[5] See, for example, "A Simple, Progressive Replacement for the AMT," *Tax Notes*, June 4, 2007, pp. 945-955.
[6] See note 3, p. 53.
[7] Congressional Budget Office, "CBO's 2011 Long-Term Budget Outlook," p. 62.
[8] See note 7.

Adjustments

There are a number of areas as follows that require adjustments under IRC § 56(a), in many cases with complicated calculations. The adjustments tend to have the effect of deferring certain deductions or recognizing income sooner.

1. Depreciation. Where personal property has been depreciated for regular tax purposes using the 200% declining balance, depreciation needs to be recomputed using the 150% declining balance method. In addition, taxpayers are required to switch from the declining balance method to the straight-line method in the first year that maximizes the deductions. Thus, the positive adjustments in the first few years of ownership will be offset by negative adjustments in the later years of ownership. For real property, taxpayers are required to use 40-year straight-line depreciation although for regular tax purposes, they may have used 39 or 27.5 year depreciation. This adjustment is no longer necessary for acquisitions of real property after 1998, but adjustments are still required for real property acquired before 1999.

2. Circulation, Mining Exploration, and Research and Development Expenditures. Circulation expenditure of periodicals must be amortized equally over three years (where they may be fully deducted for regular tax purposes) and mining and research expenditures must be amortized ratably over 10 years (where they might be amortized over five years for regular tax purposes). The basis for gain or loss determination is computed using the AMTI basis. Certain deductions related to pollution control facilities are not allowed. The credit allowed for alcohol and biodiesel fuels is included in income.

3. Incentive Stock Options (ISOs). The excess of the stock's fair market value at the time of the exercise of the ISOs over the amount paid for the stock must be included as an adjustment.

4. Passive Farming Losses. No deduction is allowed for losses from farming activities in which the taxpayer does not materially participate.

5. Net Operating Losses. Complicated rules must be applied where net operating losses (NOL) have been used. The regular NOL must be adjusted for AMTI adjustments and tax preferences.

6. Long-term Contracts. The percentage-of-completion method must be used for AMT purposes instead of a completed contract method.

7. Personal Exemption. The personal exemptions taken for regular purposes need to be added back as an adjustment in computing AMT. However, a separate exemption for AMT purposes can be taken although it is subject to a phase-out.

8. Standard Deduction. The standard deduction is not allowed for the AMTI computation.

9. Itemized Deductions. There are a number of adjustments relating to itemized deductions. Medical expenses are deductible for AMTI purposes only to the extent they exceed 10% of AGI. Since the percentage for regular tax purposes is 7½%, there is a maximum 2½% adjustment that is necessary for AMT purposes. If the actual deduction taken for regular purposes is less than the 2½% adjustment, the actual deduction would be the adjustment. Virtually all state and local real property taxes, personal property

taxes, and income taxes must be added back as an adjustment for AMT purposes (except the windfall profit tax and the generation-skipping tax imposed on income distributions). While the home mortgage interest deduction is generally allowed for AMT purposes, the amount of the deduction taken on a regular tax return because of home equity loan interest must be added back for AMT purposes. Investment interest expense up to the amount of net investment income is allowed. Miscellaneous itemized deductions are generally not allowed for AMTI calculations except for wagering losses, deductions for impairment-related work expenses, deductions for estate tax relating to income in respect of a decedent, and an assortment of other less common deductions. In the years when some of the itemized deductions are phased out, the phase-out must be added back to AMTI. If an AMT is due, the taxpayer may be able to lower his or her total tax (regular tax plus AMT) by claiming itemized deductions on Form 1040, even if the total itemized deductions are less than the standard deduction. This is because the standard deduction is not allowed for the AMT and, if one claims the standard deduction on Form 1040, one cannot claim itemized deductions for the AMT.

10. Other Adjustments. When a taxpayer is required to recognize gain or loss on disposal of a depreciable asset, the gain or loss must be adjusted to reflect the AMT depreciation amount rather than regular depreciation amounts. Passive activity gains and losses must be refigured for the AMT by taking into account all adjustments and preferences and any AMT prior year unallowed losses that apply to that activity. The amount of any AMT passive activity loss that is not deductible and is carried forward is likely to differ from the regular tax amount. If a charitable contribution of property was made to which Section 170(e) applies and there is a different basis for AMT purposes, an adjustment may have to be made. For the regular tax, some deductions are credits and may result in carryforwards to other tax years. Examples are investment interest expense, a net operating loss, a capital loss, a passive activity loss, and the foreign tax credit. Because one may have to refigure these items for the AMT, the carryback or carryforward amount may be different for the AMT than for the regular tax. The at-risk limits and basis amount also may differ for the AMT. Therefore, one must keep records of these different amounts.

Tax Preferences

There are a number of tax preferences that have to be added to taxable income to arrive at AMTI under IRC § 57.

1. Depletion. The excess of the percentage depletion deduction over the adjusted basis of the property at the end of the year is added as a tax preference for all minerals.

2. Intangible Drilling Costs. There is a tax preference for intangible drilling costs on oil, gas, and geothermal wells equal to the amount of excess intangible drilling costs over 65% of the net income from the resource properties. Excess intangible drilling costs are the amount by which the intangible drilling deduction for regular tax purposes exceeds the amount which would have been allowable if the costs had been capitalized and amortized over 120 months.

3. Tax-Exempt Interest. Although tax-exempt interest is generally not a tax preference item, the tax-exempt interest on private activity bonds issued after August 7, 1986, is a tax preference. The preference does not apply to bonds issued for the benefit of tax-exempt charitable or education institutions or for bonds issued for public purposes such

as schools and municipally owned public utilities, nor does it apply to tax-exempt interest in private activity bonds issued in 2009 and 2010.

4. Accelerated Depreciation or Amortization. There is a tax preference for accelerated depreciation on real property before 1987 that is in excess of straight-line depreciation. There is also a tax preference for amortization of certified pollution control facilities for the excess of 60-month amortization over depreciation otherwise allowable.

5. Exclusion for Gains on Sale of Certain Small Business Stock. There is a tax preference for the amount equal to 7% of the amount excluded from income under IRC § 1202 allowing taxpayers to exclude up to 50% of the gain on the sale of certain small business stock held more than 5 years. Thus, 3½% of the gain is treated as an AMT preference. In future years, the AMT preference will vary depending on when the stock was purchased.

6. There is no AMT adjustment if the taxpayer elects to deduct the following items ratably over the period of time shown:

   - Circulation expenditures – 3 years
   - Research and experimental expenditures – 10 years
   - Mining exploration and development costs – 10 years
   - Intangible drilling costs – 60 months

Exemption

There is a sizeable exemption allowed for AMT purposes; however, unfortunately for many taxpayers, it is phased out if AMTI exceeds certain amounts. For 2011, the exemption is $74,450 for joint filers and surviving spouses, $48,450 for single individuals, and $37,225 for married individuals filing separately or estates and trusts. The exemption amounts are reduced by 25 cents for each $1 by which AMTI exceed $150,000 for joint filers, $112,500 for single taxpayers, and $75,000 for married individuals filing separately. Thus, for example, if the AMTI were greater than $447,800 for joint filers, there would be no deduction for an exemption. In effect, the phase-out could make the 28% higher marginal AMT tax rate equivalent to an effective rate of 35% (1.25 x 28%) at levels above the phase-out point.

Calculation of the AMT

The rate applied to the AMTI is 26% on the first $175,000 and 28% on the remaining amount of AMTI. In addition, dividends taxed at 15% and long-term capital gains at 15% and 25% for regular purposes are taxed at the same rates for AMT purposes.

Tax Credits

Only the personal nonrefundable tax credits and the foreign tax credit reduce the AMT liability for individual taxpayers. Thus, the general business credit is not available against the AMT in certain situations. The general business credit is taken only to the extent that it reduces the regular tax to the tentative minimum tax. This is to the benefit of taxpayers since taxpayers then will not be in a situation where the business credit reduces the regular tax and then the AMT is increased to offset the business credit taken. In other words, this provision often allows the general business credits to be retained for carryback or carryforward purposes. A few of the

personal nonrefundable tax credits have been made permanent against the AMT. The others must be renewed each year. The foreign tax credit is based on AMT income rather than regular income.

The AMT paid in one year may be carried forward indefinitely as a credit against the regular tax liability; however, the credit may not be used to offset any future minimum tax liability. Again, the taxpayer is not allowed to take a credit larger than the amount necessary to reduce the regular tax to the amount of the tentative minimum tax.

Tax Planning

Some taxpayers are sophisticated enough to do some tax planning that may reduce their AMT liability. Other taxpayers simply do not understand the AMT well enough to avoid the AMT and therefore get caught off-guard when their tax preparer software or their tax preparer inform them that they are being subject to the AMT. Planning becomes especially difficult because Congress usually waits until the end of the year to make their annual patches to the AMT. The types of tax planning recommended are tricky since taxpayers should only accelerate receipt of income or defer expenses up to the point where the tentative minimum tax equals the regular tax.

Sometimes it might be advantageous to accelerate income into an AMT year since the AMT rates of 26% and 28% are less than the highest regular tax rates with which one might be faced. Accelerating income could be accomplished by taking capital gains before year-end, receiving bonuses and commissions before year-end, redeeming Treasury bills and U.S. savings bonds before year-end to recognize multi-year accruals, or exchanging tax-exempt bonds for taxable bonds paying higher interest rates. Taxpayers holding private-activity bonds might wish to trade these bonds for regular municipal bonds or for taxable bonds with higher interest rates.

On the other hand, if taxpayers were certain they would not be subject to the AMT, they might want to incur expenses so as to reduce their regular tax. They could accomplish this by moving some allowed itemized deductions that would not be lost if they were subject to the AMT, such as charitable contributions, to the regular tax year where they could reduce taxes up to 35%.

PROPOSALS FOR DEALING WITH THE AMT AND ITS PROBLEMS

Various methods of dealing with the AMT and its problems and complications are possible, all of which have advantages and disadvantages.

Modification of Existing AMT Structure

One alternative is to modify the basic structure of the AMT. This could be done through revisions of any one or more of the following provisions or items.

The AMT exemption amount could be indexed for inflation, and/or increased significantly. This would eliminate the need for Congress to have to annually raise the exemption amount. More importantly, the phase-out of exemption could be eliminated. This, of course, would allow taxpayers to know just exactly what their exemptions were without having to be concerned that the phase-out would reduce the benefit of the exemption.

It would be possible to eliminate some very common adjustments. For example, the adjustment for state and local property and income taxes could be eliminated so that these tax deductions could be retained for AMT purposes. Taxpayers count on these deductions for regular tax purposes and to have them eliminated is very frustrating to taxpayers.

Another modification to the AMT would be to eliminate the need to make any adjustments relating to depreciation. There already has been a reduction in the need for an adjustment relating to depreciation, such as the provision that taxpayers no longer need to make the depreciation adjustment for acquisitions of real property after 1998.

A modification to allow common miscellaneous itemized deductions could be helpful to taxpayers. Although there are some miscellaneous itemized deductions that are allowed (such as wagering losses), many (such as employee-related expenses or investment-related expenses) need to be added back as an adjustment. Eliminating this adjustment would allow taxpayers to "keep" the deductions that they were entitled to for regular tax purposes.

Interest on mortgages could be totally retained even if it was interest on home-equity loans. This would eliminate the need for any adjustment relating to mortgage interest.

Another modification would be to decrease the AMT rates so that not so many taxpayers would be subject to the AMT. This would help coincide with the individual tax rates that have decreased to a maximum of 35 percent. Perhaps the AMT rate could go down to 21% like it was a couple of decades ago.

Sometimes taxpayers criticize the triggering of the AMT when there are ISOs and the difference between the fair market value and the exercise price has to be included as a tax preference even when no stock is actually sold. The inclusion of unrealized gain on ISOs imposes difficulties for people who cannot come up with cash to pay tax on gains that they have not realized yet. A number of taxpayers have been heavily penalized by this inclusion in AMT and then their stock declines significantly in value before they can sell the stock. Perhaps this adjustment could be eliminated. In 2008, Congress put in a special law to abate the AMT liability stemming from the exercise of ISOs.

Modification of the existing AMT structure for some or many of the above possible changes would still not totally solve the AMT problem. There would still be complexities in calculating AMT and uncertainties in tax planning.

Change the Regular Income Tax Structure

Another alternative to at least alleviate the AMT problem would be to change the regular income tax structure in such a way that the areas that cause taxpayers to be subject to the AMT would be eliminated from the regular tax structure. Some might argue that if income were taxed comprehensively by the regular tax code, there would be no need for the AMT. The AMT problem is caused by what some might claim are unjustifiable deductions on taxable income that cause taxpayers to be subject to the AMT. For example, the following changes in the regular income tax structure could occur:

1. Eliminate the deduction for state and local real and personal property taxes;

2. Eliminate the deduction for state and local income taxes;

3. Eliminate the allowed miscellaneous itemized deductions that would be added back as an adjustment for AMT purposes;

4. Make depreciation consistent for regular and AMT purposes;

5. Do not allow percentage depletion for regular purposes.

Such actions might keep some taxpayers from being subject to the AMT or might reduce the AMT problem for other taxpayers, but the changes would not totally eliminate the AMT problem.

Total Repeal of the AMT

Total repeal of the individual AMT would be an alternative that should be considered so that taxpayers would not be subject to the AMT when it was not originally the intention of the Congress to subject many of these taxpayers to the AMT. Although some might argue that the revenue lost from not having the AMT would be too great, Congress could increase the top ordinary income tax rates. At least, the tax liability then would be more predictable than it is under current law where taxpayers are often taken by surprise when they find out they are subject to the AMT. Further, many of the tax loopholes that were causing taxpayers with high income to not pay income taxes have been eliminated through provisions such as the at-risk rules enacted in 1976 and the passive loss rules enacted in 1986. It is simply not fair to give taxpayers benefits and deductions for regular tax purposes and then have them taken away through the AMT.

Those who argue against repeal would say that most of the AMT is paid by taxpayers having fairly high incomes, generally at least in the $150,000 to $200,000 range, and they should be prepared to pay taxes. Some argue that the focus should be on making sure that those with lower incomes are not subject to the AMT.

AUTHORS' RECOMMENDATION

The authors recommend that the AMT be totally repealed. In this time when significant individual tax reform is proposed, it would now be an excellent and appropriate time to totally eliminate the AMT. This complicated and burdensome tax definitely causes too many problems for too many taxpayers. Not only are the computations difficult, but tax planning is too complicated because most taxpayers simply do not understand what it takes to avoid or minimize the AMT.

If Congress believes too much revenue would be lost if the AMT were repealed, it could legislate a tax increase at higher levels of income to cover the revenue loss. At least taxpayers would be able to better predict their tax liability than they presently are and they would not be taken by surprise by the AMT. Further, many of the tax loopholes that originally were present and gave rise to the original AMT legislation have been closed with tax shelter changes under the at-risk rules and the passive loss rules. It is not fair that taxpayers who have counted on tax provisions for a long time should lose them through the AMT. To have bad tax law in effect principally because Congress desires to retain the AMT in order to obtain tax revenue is just not good tax policy.