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The alternative minimum tax

Tax-saving strategies

The alternative minimum tax (AMT) was originally designed by Congress to ensure that wealthy individuals could not avoid income tax by exploiting weaknesses in the tax code. When the AMT was introduced in 1969, it only affected taxpayers with very high incomes. But, until recently, AMT rules were not indexed for inflation. Over the past 40 years, economic growth and inflation have caused wage levels to increase significantly, yet the income threshold above which individuals must figure their AMT liability stayed level, resulting in an expansion of the AMT.

The signing into law in early 2013 of the American Taxpayer Relief Act of 2012 brought some much-needed clarity to the AMT system. Unlike previous legislation to index the AMT for inflation, this law enacted that change on a permanent basis. The AMT exemption amount was increased for inflation going forward. This prevented a dramatic expansion of the AMT to many more taxpayers.

2017 AMT exemption amounts

Single filers $54,300

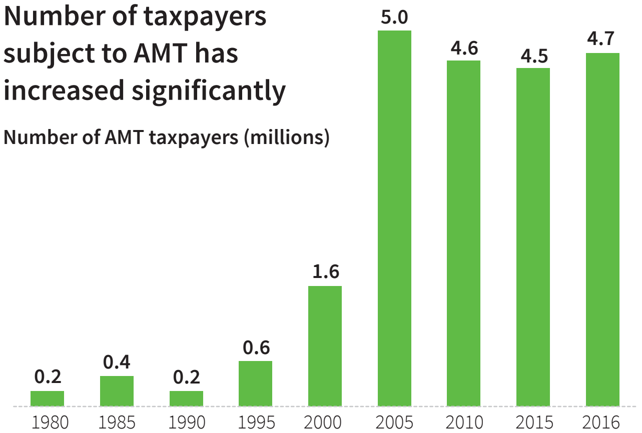
Married/filing jointly $84,500

The permanent increase in the exemption amounts means less income will be subject to the AMT. However, there are still a significant number of taxpayers who will feel the burden of the AMT each year. Fortunately, there are strategies you can use to reduce the likelihood you'll have to pay the AMT.

Taxpayers with incomes above $100,000 should complete IRS Form 6251 to see if they owe the AMT.

Number of taxpayers subject to AMT has increased significantly

Number of AMT taxpayers (millions)



Source: Tax Policy Center, October 2016.

Will you owe the AMT?

Your income	Chance that you will owe the AMT
Less than $100,000	Less than 1%
$100,000–$200,000	2%
$200,000–$500,000	31%
$500,000–$1,000,000	62%
Over $1,000,000	18%

Source: Urban-Brookings Tax Policy Center, October 2016 estimates.

The nature of the tax

The alternative minimum tax is a separate, parallel federal income tax system, with two marginal tax rates, 26% and 28%, and different exemption amounts. Under AMT rules, certain exclusions, exemptions, deductions, and credits that would reduce your regular taxable income are not allowed. You must "adjust" your regular taxable income to arrive at your alternative minimum taxable income (AMTI).

Then, after subtracting your AMT exemption amount, if your AMT liability is greater than your regular tax liability, you must pay both your regular tax and the difference. It is important to understand that a higher level of income will not necessarily cause you to owe the AMT. Rather, it is the relationship between your income and various trigger items that determines your AMT liability. Managing this relationship can help avoid a costly surprise at tax time.

Any number of items may trigger the tax, but large capital gains, personal exemptions, and deductions are the worst culprits. The following is a list of the most common items that may affect your taxable income for AMT purposes, and your potential AMT liability.

Adjustments to your taxable income

Once you've determined your regular taxable income, you must make adjustments to arrive at your AMTI. The following is a summary of typical deductions and credits that are not allowed under AMT rules. Because you cannot claim them, your taxable income for AMT purposes will likely be higher than your regular taxable income. However, some AMT adjustments will lower your AMT income, for example, the AMT exemption. Consult your tax advisor for more information.

- **Incentive stock options** Exercising incentive stock options is typically a triggering item because under AMT rules, you have to recognize as income the "spread" between the market price and the exercise price of your options.
- **Personal exemptions** Personal exemptions are not allowed under AMT rules. Each exemption ($4,050 in 2017) you claim on Form 1040 for yourself, your spouse, and your dependents represents taxable income for AMT purposes.
- **Standard deduction** The standard deduction is not allowed under AMT rules. Without the benefit of this deduction (in 2017, $12,700 for joint filers; $6,350 for singles), your AMTI is higher.
- **Interest on second mortgages** For regular tax purposes, interest on home equity mortgages up to $100,000 is deductible, even if you used the proceeds for personal purposes, such as buying a car or paying off credit card debt. If you use the proceeds from a second mortgage for a purpose other than financing a home or making home improvements, the interest deduction is not allowed under AMT rules.
- **Miscellaneous itemized deductions** If you claim a large number of miscellaneous deductions and they total more than 2% of your adjusted gross income (AGI), you may end up owing the AMT. These items might include unreimbursed employee expenses, tax preparation fees, and investment expenses.
- **State and local taxes** Deductions for state and local taxes, including property tax, state income tax, and state sales tax, are not allowed under AMT rules. The higher your state and local tax deductions (if you itemize), the greater the likelihood that you'll owe the AMT. People who live in high-tax states are especially vulnerable.
- **Various credits** Certain credits are not allowed under AMT rules. The more credits you claim on your regular tax form, the more likely it is that you'll qualify for AMT status.

Other potential AMT items

The AMT was designed to target the wealthy. The following items are found more often on the tax returns of wealthy individuals and can generate substantial tax revenues. Under AMT rules, they are not afforded the favored tax treatment they receive under the regular tax rules.

- **Tax-exempt income** Interest income from most "private activity" municipal bonds is taxable under AMT rules. Such bonds typically pay a higher yield to compensate investors for their AMT exposure.
- **Long-term capital gains** Since phase-outs apply to the AMT exemption amount at higher income levels, a particularly large capital gain may increase your AMT exposure. For 2017, these income phase-outs begin at $120,700 for individual taxpayers and $160,900 for couples. In addition, under AMT rules, there are fewer deductions to offset a large gain. Consider delaying the sale of a highly appreciated asset until a year when your AMT exposure will be lower.
- **Tax shelters** Although most tax shelters were eliminated in the Tax Reform Act of 1986, certain shelters still exist, such as oil and gas drilling or other types of limited partnerships. Investing in such a tax shelter may increase your chances of paying the AMT.

Strategies to reduce or avoid your AMT exposure

Managing the relationship between your regular taxable income and the deductions you take on Form 1040 is the key to avoiding or reducing your AMT liability. You can manage this relationship by accelerating your income and delaying certain deductions. Working with a qualified tax advisor throughout the year, rather than just at tax time, will help you achieve the best results.

- **Select municipal bonds wisely** If you think you may be subject to the AMT, invest in tax-exempt bonds that are not private activity bonds, or convert some of your AMT bond holdings to non-AMT bond holdings. There are municipal bond mutual funds that specifically avoid AMT exposure. You might also consider investing in higher-yielding taxable bonds.
- **Accelerate income** To the extent that you can control cash flows within a given year, consider accelerating income receipts in order to report higher regular income relative to your deductions. For those who are definitely subject to the AMT, receiving more income may result in a lower marginal minimum tax rate of 26% on the first $187,800 of the AMTI and 28% on amounts in excess of that threshold, versus the maximum 39.6% federal ordinary income tax rate. However, before accelerating income, taxpayers should consider the new Medicare net investment income surtax of 3.8%, which begins at income levels above $200,000 for individuals and $250,000 for couples (based on modified adjusted gross income).
- **Defer deductions** The tax-saving advantage of certain deductions will be lost if claimed in a year when you will owe the AMT. For such a year, plan the timing of your deductible expenses, particularly tax and medical payments, to achieve fewer deductions relative to your regular taxable income.
- **Proceed with caution with incentive stock options** The decision to exercise incentive stock options should be made with the help of a qualified tax advisor. If exercising the options would result in you owing the AMT, you could wait until a year when the tax ramifications are more favorable.

FIND YOUR AMTI

Taxable income for regular tax purposes
+ or – AMT adjustments
+ AMT preference items
– AMT exemption

Alternative minimum taxable income (AMTI)

COMMON AMT TRIGGERS

- You claim exemptions for several dependents
- You deduct interest on second mortgages
- You have large capital gains
- Your state and local taxes are high
- You exercised incentive stock options

WAYS TO ACCELERATE YOUR INCOME

- Take salary and bonuses early
- Redeem series EE U.S. savings bonds
- Redeem certificates of deposit
- Convert tax-free bonds to higher-yielding taxable bonds
- Take distribution from IRA or other retirement funds

WAYS TO REDUCE YOUR DEDUCTIONS

- Take advantage of employer's pretax medical deduction plan
- Do not prepay real estate or fourth-quarter state estimated taxes
- Negotiate to have employer reimburse you for employee business expenses

Consult with a qualified tax advisor

The alternative minimum tax system is complex, and every individual's tax situation is unique. As a general rule, taxpayers with annual income over $100,000 should consult with a qualified financial representative and/or tax advisor to determine whether they will owe the tax. Using prior years' tax information, your representative or advisor can project W-2 and other income, estimate your capital gains and deductions, and use specialized software to forecast whether you will be subject to the AMT. Advance planning is the best way to develop satisfactory strategies for minimizing tax liability this year and in the future.

Putnam Retail Management

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