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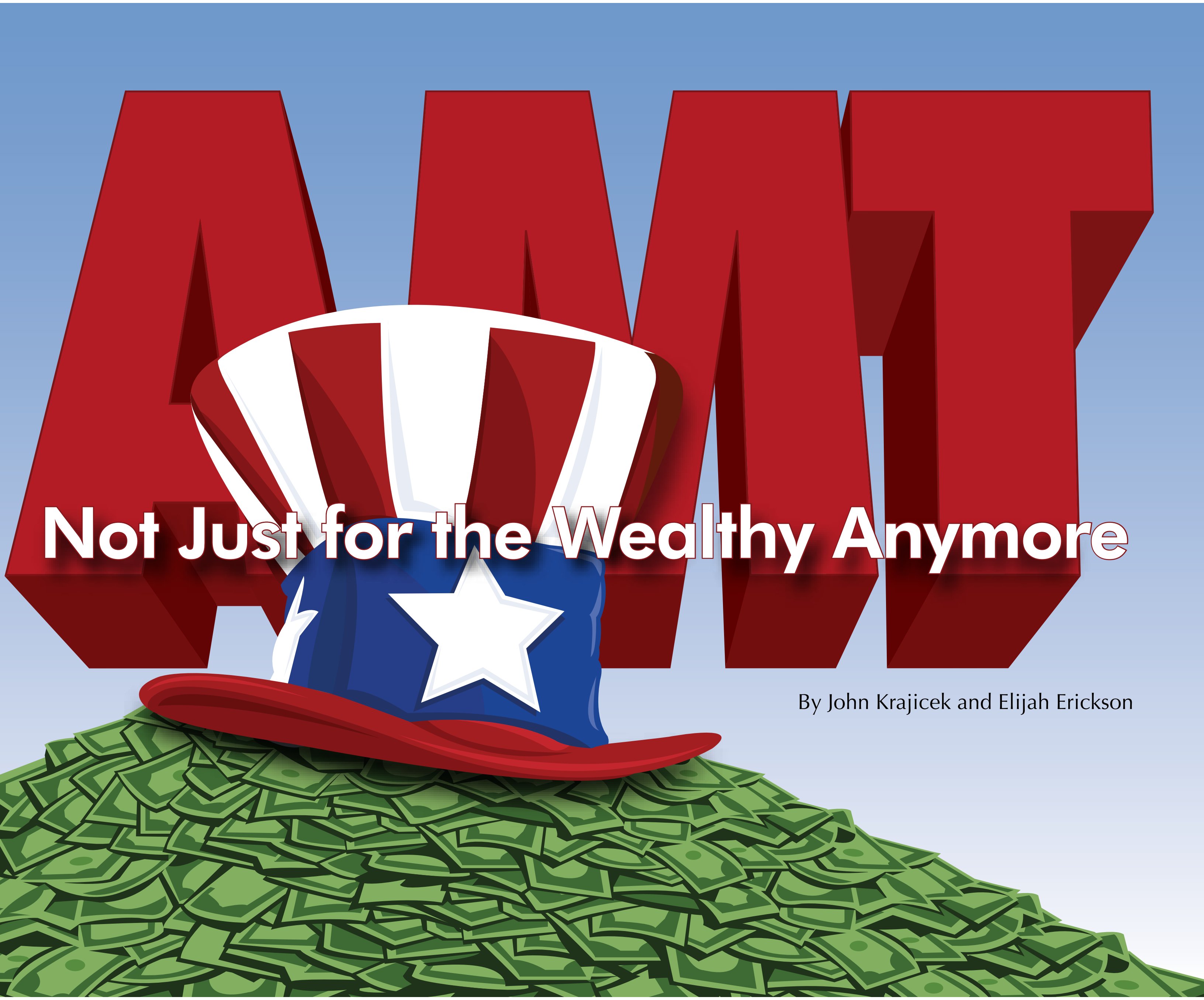

AMT: Not Just for the Wealthy Anymore

By John Krajicek and Elijah Erickson

The year 1969 is usually remembered as the year Neil Armstrong walked on the moon, Richard Nixon became president, and the music festival Woodstock took place on a farm in New York. According to U.S. Commerce Department reports, the average U.S. household income in 1969 was $9,430, and the average cost of a new home was $24,000. That year, Congress passed new tax legislation known as the Alternative Minimum Tax (AMT).

The AMT was designed as a new alternative to the regular income tax calculation. Applicable only to individuals earning over $200,000 (well over $1 million in today's inflation-adjusted dollars), it was essentially implemented to catch a small percentage of wealthy taxpayers who were exploiting tax loopholes to minimize or even avoid federal income tax altogether. The AMT required these high-income earners to pay at least a *minimum* threshold of taxes. However, because subsequent Congresses have not indexed the AMT for inflation (unlike the regular tax system, which *is* inflation indexed), an alarmingly larger percentage of taxpayers become subject to this tax every year.

Chances are that many people reading this may already be impacted by the AMT, whether they are wealthy by today's standards or not. A surprising number of people don't even realize they are paying AMT. Taxpayers should be aware of the unintended but so far uncorrected negative consequences of not indexing the AMT for inflation.

But before we weigh these matters further, let's back up for a brief historical review.

Historical Perspective

The AMT was originally created by the Tax Reform Act of 1969. It was designed to operate as a parallel tax calculation to prevent high-income individuals from using federal income loopholes, preference items and excessive deductions to avoid federal income taxes.

Fast forward to the 1980s. In the Tax Equity and Fiscal Responsibility Act of 1982 and the Tax Reform Act of 1986, the AMT evolved into its present form. The AMT rate was set at 26 percent for taxable income up to $175,000 and 28 percent for income above this threshold. This percentage is lower than the corresponding regular federal income tax rate, so at first glance the AMT does not appear onerous. But these rates are deceptive because they apply to a broader base of income, which in turn eliminates a number of exemptions and deductions.

The biggest flaw with these tax reform acts was that they did not index the AMT exemption to inflation. In 1986, an annual income of $130,000 was a lot of money. But today, according to salary.com, it represents approximately the annual income of a Houston police officer married to a nurse. That's not the type of people the tax was intended for. Yet, today, this couple may be required to pay the AMT (see table).

Comparison of Standard and AMT Calculations for Houston Police Officer and Nurse

Married Filing Jointly	2011		2012
	Standard	AMT	AMT
Gross Income	$130,000	$130,000	$130,000
Personal Exemptions	$18,500	$ –	$ –
AMT Exemption	$ –	$74,450	$40,000
Itemized Deductions			
Primary Home Mortgage Interest	$15,000	$15,000	$15,000
State Taxes	$8,000	$ –	$ –
Gifts to Charity	$12,000	$12,000	$12,000
Other Miscellaneous Deductions	$3,000	$ –	$ –
Taxable Income	$73,500	$28,550	$63,000
Effective Tax Rate	14.45%	26%	26%
Tax	10,619	7,423	16,380
Child Tax Credit	1,000	–	–
Total Tax Liability	$9,619	$7,423	$16,380

Source: Tax scenarios based on salary information from www.salary.com and tax information from www.irs.gov.

Subsequent Congresses have revisited the AMT exemption amounts over the last 26 years, but the results have mostly been cosmetic changes. Between 1990 and 2009, Congress passed a series of "patches" that acted as temporary inflation indexes for the AMT. The latest AMT adjustment was made in 2009 as part of the American Recovery and Reinvestment Act. However, this patch expired on Jan. 1, 2012.

In the 40-plus years since the AMT was signed into law, it has continued to cast an ever-widening net. According to a recent Congressional Budget Office brief, less than 1 percent of taxpayers were affected by AMT in all of the 31 years leading up to the year 2000. Shockingly, most estimates say that one-third of all taxpayers will be subject to the AMT in 2012. And without inflation indexing, this number will only grow. Houston, we have a problem!

ABCs of AMT

So how does this tax work?

We've all heard about people cheating the IRS by keeping "two sets of books." The AMT in essence requires taxpayers to keep two sets of books, and operates as a mandatory "parallel" tax system.

The first set of books is the federal income tax, which is calculated using Form 1040. To determine income tax liability, taxpayers begin with their annual gross income and subtract the appropriate exemptions and deductions. This results in taxable income. The applicable tax rates are then applied to determine income tax liability.

The alternative set of books begins where the first one ends. To calculate AMT liability, federal taxable income is modified to derive Alternative Minimum Taxable Income (AMTI), by adding back personal and dependent exemptions and a potentially large number of deductions. The AMT exemption is then applied, which in the case of a married couple filing jointly, is $74,450 in 2011. Finally, the AMT rates are applied to AMTI to come up with the AMTI liability.

Once both sets of books have been calculated and both potential tax liabilities identified, the two amounts are compared. The tax liability is whichever amount is greater.

The AMT system differs from the regular tax system in that it disallows all personal exemptions and many deductions. In fact, it looks a little like a flat tax. Two of the lost deductions are property taxes and home equity mortgage interest. State and local taxes are also disallowed, as are miscellaneous itemized deductions, a portion of otherwise deductible medical expenses, and certain business expenses. In addition, the AMT calculation negatively affects depreciation rates.

The AMT simplifies the calculation of taxable income (again, somewhat like the flat tax proposals) but increases the base of income that is taxed. It also employs a simplified rate structure. Unlike the many tax "brackets" in place for the regular tax, the AMT has only two rates — 26 percent on the first $175,000 of AMTI and 28 percent on any excess.

Using the middle-class Houston police officer and nurse as an example, the table walks us through a simplified regular income tax AMT calculation. In this case, which assumes the couple has three children, the tax liability under the regular tax system is $9,619. Under the mandatory alternative system, it is $7,423.

This couple is liable for the greater of the two, or $9,619. However, in 2012, based on the same income and deductions, the AMT exemption drops and the tax bill under AMT increases by 70 percent to $16,380.

It's income tax time again, Americans: time to gather up those receipts, get out those tax forms, sharpen up that pencil, and stab yourself in the aorta.
~Dave Barry

New Alternative

Because of the lack of indexing, the AMT net is expanding and will soon "catch" the middle class. We venture a guess that over half of those who read this publication will pay AMT in the 2012 tax year unless Congress acts.

So, the question for 2012 is whether Congress even has the political will to debate adjusting the tax for inflation. Given the economy's precarious state and the large government deficit, Congress may allow the AMT exemption to drop back to the $40,000 level set in the 1980s. The effect would be to eliminate inflation-indexing and impose this "wealth tax" on average taxpayers. If that happens, the tax will no longer be an alternative tax. In fact, the AMT seems destined to supplant the regular tax system.

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THE TAKEAWAY

The Alternative Minimum Tax (AMT) was created in 1969 to ensure that high-income taxpayers (those making over $200,000) would not avoid paying taxes by exploiting tax loopholes. But because the AMT was not indexed for inflation, people who are not wealthy by today's standards are now subject to the tax.

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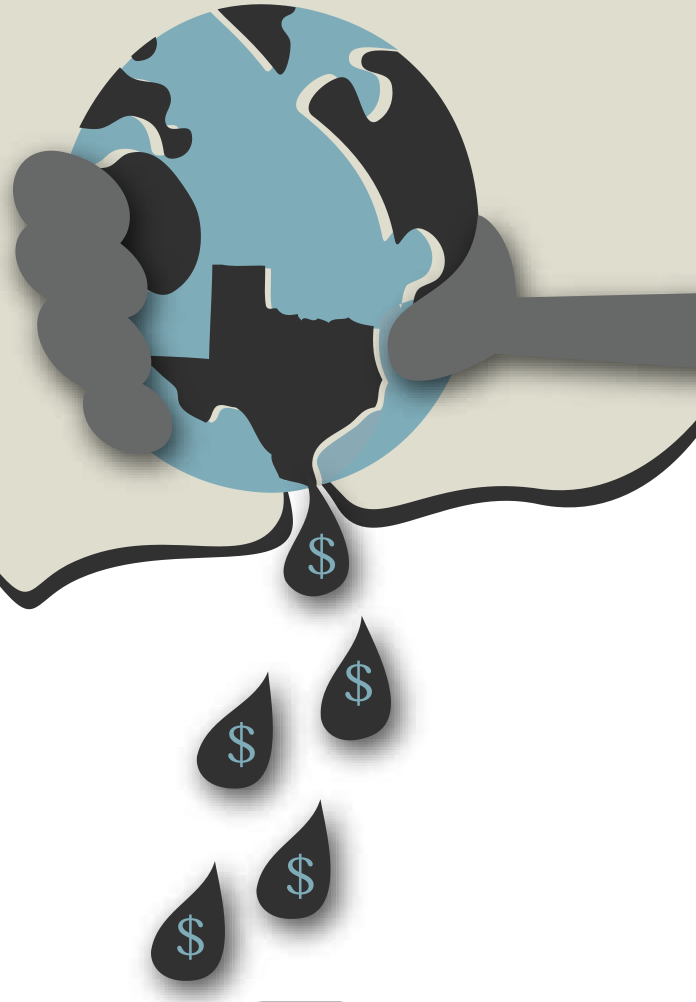
The oil and gas reviews are in!



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