Alternative Minimum Tax

# Introduction

The alternative minimum tax (AMT) is in essence an income tax system that runs parallel to the “normal” federal income tax system. It is intended to impose a tax on certain taxpayers who have taken advantage of certain tax deductions, such as state and local taxes, or “preferences,” which are items the taxpayer is deemed to be receiving special tax treatment.

While many individual taxpayers are able to complete and file their tax returns by simply filling out Form 1040 and a few supporting schedules, an increasing number of taxpayers are unwittingly subject to the AMT. Often, the AMT is levied on taxpayers after the fact – that is, the IRS compiles the necessary information and lets the taxpayer know that he forgot to compute the AMT liability and pay the additional tax.

Individuals can determine if the AMT applies to them in a given year by preparing IRS Form 6251. Corporations are also potentially subject to the AMT and use IRS Form 4626 to see if the tax applies. These forms are generally not required to be included with the filing of the taxpayer’s return if the AMT does not result in a higher tax liability.

Trusts and estates filing income tax returns may also be subject to the AMT. These entities complete Schedule I of Form 1041 to compute their exposure. Pass-through entities like partnerships and S corporations are not subject to the AMT. However, they are responsible for reporting the applicable adjustments or preferences to the partners or shareholders on their Schedule K-1s.

Only a handful of people are even aware of the existence of this separate tax system. Far, far fewer understand how it is determined. Awareness of the AMT has been growing as more taxpayers fall under its reach. On the other hand, anyone who advises others must constantly be aware of the potential AMT impact of any recommendations that they make.

For 2013, an estimated 3.9 million taxpayers were subject to the AMT. This represents over four percent of all taxpayers.[[1]](#endnote-1) The American Taxpayer Relief Act of 2012 (ATRA) provides for permanent indexing of the exemptions, brackets, and phase-outs, which protects even larger numbers of taxpayers from being caught in the snare of the AMT.

# How is AMT Determined for Individuals?

The AMT is assessed at a rate of 26 percent of alternative minimum taxable income (AMTI) up to $175,000 ($87,500 for married taxpayers filing separately) and 28 percent

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of AMTI exceeding that amount.[[2]](#endnote-2) Preferential tax rates for long-term capital gains and qualifying dividends are also used in determining an individual’s AMT.[[3]](#endnote-3)Beginning in 2013, the income thresholds are indexed for inflation. The applicable amount for 2014 is $182,500 for all taxpayers except those married filing separately, which is half of this amount.

With a maximum tax rate of 28 percent, many taxpayers automatically (and incorrectly) assume that if they are in the 28 percent tax bracket or above, the AMT could not possibly apply to them. How is it possible that the AMT would apply when my marginal tax rate is higher than the maximum AMT rate? The answer lies in the differences between the computation of regular taxable income and AMTI. A myriad of add-backs and special tax rules mean that a taxpayer may have an AMTI that is significantly higher than his or her regular taxable income.

A taxpayer’s AMTI and AMT are computed as follows:

*Step 1: Adjust taxable income.* First, compute taxable income using Form 1040[[4]](#endnote-4)then add or subtract the adjustments to taxable income (as discussed below).[[5]](#endnote-5)

*Step 2: Add the amount of preference items.* “Preference items” are specific tax items, discussed below, on which the taxpayer is receiving preferential tax treatment.[[6]](#endnote-6) **The result is the taxpayer’s AMTI.**

*Step 3: Compute the applicable exemption amount.* Like the regular taxable income, the AMTI has exemption amounts that are based on the taxpayer’s filing status. Unlike the exemptions for regular taxable income, the AMTI exemptions are phased-out for incomes above certain thresholds.

For 2014, exemption amounts can be up to 82,100 for a married couple filing jointly, $52,800 for a single taxpayer, or $41,040 for a married individual filing separately.[[7]](#endnote-7) The actual allowable exemption is computed by reducing the exemption limits above by 25 percent of the amount by which AMTI exceeds certain levels. Those levels are $156,500 for married taxpayers filing jointly, $117,300 for single taxpayers, and $78,250 for married taxpayers filing separately.[[8]](#endnote-8)

Note that the reduction in AMTI exemption means that taxpayers with income above certain levels effectively have no exemption. In 2014, the exemption is completely phased out for joint filers with AMTI in excess of $482,300, single filers with AMTI over $328,500, and spouses filing separately with AMTI more than$242,410 for married individuals filing separately.

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Related to the phase-out of the exemptions is a provision for certain married individuals who file separate returns to increase their AMTI. In 2014, a married individual filing a separate return must increase AMTI by the lesser of (a) 25 percent of the excess of the AMTI over $242,410, or (b) $41,040.[[9]](#endnote-9)

*Step 4: Compute the AMT*. The tax rates are then applied to the taxpayer’s AMTI (less any exemption) to yield the “tentative minimum tax.” If the tentative minimum tax computed under this formula does not exceed the taxpayer’s regular tax, the AMT does not apply. If the computed tentative minimum tax exceeds the taxpayer’s regular tax, the excess of the tentative minimum tax over the regular tax is the AMT that is added to the tax liability computed in the normal manner.

*Example*. Assume Dr. and Mrs. Ginsburg file a joint return for 2014. They have two dependent children. Their regular tax was computed to be $25,463.

|  |  |
| --- | --- |
| Joint taxable income: | $135,000 |
| AMT adjustments to taxable income: | 30,000 |
| Total of tax preference items: | 57,000 |
| **Subtotal:** | **$222,000** |
| Tentative AMT exemption: | $82,100 |
| Reduction of AMT exemption: | $16,375 = 25% of ($222,000 – 156,500) |
| Actual AMT exemption (after reduction:  | $65,725 |
| Alternative minimum taxable income (AMTI): | $156,375 |
| Tentative minimum tax: | $40,632 |

The excess of the Ginsburgs’ tentative minimum tax ($40,632) over their regular tax ($25,463) is $15,169. This amount becomes their alternative minimum tax liability and is added to their regular tax. They would therefore pay a total tax of $40,632.

# How is AMT Determined for Corporations?

Corporations were first made subject to the AMT with the imposition of the Tax Reform Act of 1986. Only S corporations and certain small corporations that qualify for an exemption are not subject to the AMT. In the case of S corporations, the adjustments and preferences are determined at the corporate level and are passed on to the shareholders on Schedule K-1 each year.

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The corporate AMT is assessed at a rate of 20 percent of the “corporate AMTI.” If this tentative minimum tax exceeds the regular corporate tax, the excess is the AMT for the year. Figure 9.1 provides detailed instructions for calculating a corporation’s AMT.

|  |
| --- |
| Figure 1 |
| Calculation of Corporate AMT |
| Step 1 | Calculate taxable income (or loss) before any net operating loss deduction using Form 1120[[10]](#endnote-10) |
| Step 2 | Add or subtract Adjustments to taxable income[[11]](#endnote-11) |
| Step 3 | Add the amount of “preference items.”[[12]](#endnote-12)The result is the *pre-adjustment AMTI.* |
| Step 4 | Adjust the pre-adjustment AMTI by either: |
| If the corporation’s adjusted current earnings (ACE) exceeds Pre-adjustment AMTI, 75 percent of the excess of ACE over Pre-adjustment AMTI is added to Pre-adjustment AMTI to yield *post-adjustment AMTI*.[[13]](#endnote-13) | If the corporation’s ACE is less than pre-adjustment AMTI, the lesser of the following amounts is subtracted from pre-adjustment AMTI to yield *post-adjustment AMTI:*• 75 percent of the excess of Pre-adjustment AMTI over ACE[[14]](#endnote-14) and• the excess aggregate upward ACE adjustments for prior tax years over the aggregate downward ACE adjustments for prior taxable years.[[15]](#endnote-15) |
| Step 5 | Subtract any allowable Alternative Tax Net Operating Loss deduction from post-adjustment AMTI. The result is the *final AMTI.*  |
| Step 6 | Calculate and subtract the applicable exemption, up to $40,000.[[16]](#endnote-16) This exemption is phased-out by 25 cents for every dollar of the amount of the corporation’s final AMTI exceeds $150,000.[[17]](#endnote-17) Therefore, at $310,000, the exemption is completely lost. Note that only one $40,000 exemption is allowed per group of controlled corporations.[[18]](#endnote-18) The exemption is allocated evenly among the group members unless an election is submitted with the tax returns of the group.[[19]](#endnote-19)**The result of this calculation is the *corporate AMTI.*** |
| Step 7 | Calculate the corporate AMT. The AMT tax rate for corporations of 20 percent is then applied to the corporate AMTI to determine the tentative minimum tax. If the tentative minimum tax exceeds the corporation’s regular tax, the excess is added to the corporation’s regular tax. |

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# What are AMT Adjustments?

A common misconception is that adjustments and preferences for AMT purposes are the same thing. In fact, adjustments and preferences are very different. AMT *Adjustments* are defined under Code section 56 and are usually amounts that are determined separately for regular tax and AMT purposes and may be positive or negative.

AMT *preferences* (see below) are defined under Code section 57 and result in add-backs to taxable income because of some “preferential” treatment received for regular tax purposes. Preferences may only result in an increase to taxable income—negative preferences are not permitted.

Adjustments for Individuals and Corporations

Three common types of adjustments to taxable income apply to both individuals and corporations. These include adjustments related to depreciation, NOLs (see Chapter 5). And gains and/or losses from sales of property.

Depreciation Adjustments

For property placed in service after 1986, depreciation deductions are adjusted to conform to special rules for the AMT.[[20]](#endnote-20) Normally taxpayers follow the MACRS rules for determining their depreciation on fixed assets, which typically results in a 200 percent declining balance method for determining the annual deduction. The applicable recovery period is determined by referring to Rev. Proc. 87-56[[21]](#endnote-21) and referring to the asset class of the property to be depreciated.

For property placed in service prior to 1999, taxpayers were required to re-compute their fixed asset depreciation using the 150 percent declining balance method and, in most cases, a longer recovery period. This led to potentially large positive adjustments for determining AMTI in the earlier years an asset was in service (i.e. higher AMTI) followed by negative adjustments in later years.

*Example:* ABC Corporation purchased $10,000 worth of furniture in 1998. The furniture has a seven-year life for regular tax purposes using the 200 percent declining balance method and a ten-year life for AMT using the 150 percent declining balance method. ABC’s depreciation calculations are:

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|  |  |  |  |
| --- | --- | --- | --- |
| Year | Regular Depreciation | AMT Depreciation | AMT Adjustment |
| 1998 | $ 1,429 | $ 750 | $ 679 |
| 1999 | $ 2,449 | $ 1,388 | $1,061 |
| 2000 | $ 1,749 | $ 1,179 | $ 570 |
| 2001 | $ 1,249 | $ 1,002 | $ 247 |
| 2002 | $ 893 | $ 874 | $ 19 |
| 2003 | $ 892 | $ 874 | $ 18 |
| 2004 | $ 893 | $ 874 | $ 19 |
| 2005 | $ 446 | $ 874 | ($ 428) |
| 2006 | - | $ 874 | ($ 874) |
| 2007 | - | $ 874 | ($ 874) |
| 2008 | - | $ 437 | ($ 437) |

For property placed in service after 1998, taxpayers may use the same recovery period that is used for determining their regular tax depreciation. However, the depreciation method still may be no faster than the 150 percent declining balance method.[[22]](#endnote-22)

*Example:* ABC Corporation purchased $10,000 worth of furniture in 1999. The furniture has a seven-year life for regular tax purposes using the 200 percent declining balance method and a seven-year life for AMT using the 150 percent declining balance method. ABC’s depreciation calculations are:

|  |  |  |  |
| --- | --- | --- | --- |
| Year | Regular Depreciation | AMT Depreciation | AMT Adjustment |
| 1999 | $ 1,429 | $ 1,071 | $ 358 |
| 2000 | $ 2,449 | $ 1,913 | $ 536 |
| 2001 | $ 1,749 | $ 1,503 | $ 246 |
| 2002 | $ 1,249 | $ 1,225 | $ 24 |
| 2003 | $ 893 | $ 1,225 | ($ 332) |
| 2004 | $ 892 | $ 1,225 | ($ 333) |
| 2005 | $ 893 | $ 1,225 | ($ 332) |
| 2006 | $ 446 | $ 613 | ($ 167) |

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In 2002 bonus depreciation became available for certain types of property placed into service on or after September 11, 2001. Originally, 30 percent of the cost of qualifying property could be deducted in the year of purchase. This was later increased to 50 percent for qualifying property purchases on or after May 6, 2003. These provisions were effective through the end of 2004.

 In 2008 50 percent a bonus depreciation allowance for qualifying property became available once again. This was increased to 100 percent for property placed into service on or after September 9, 2010, through the end of 2011. Bonus depreciation of 50 percent continued to be available for the 2012 and 2013 tax years. Currently bonus depreciation is no longer available beginning in 2014.

Taxpayers may elect to take the bonus depreciation deduction, but it is not required. Bonus depreciation is allowed for both regular tax and AMT purposes.[[23]](#endnote-23) In addition, any remaining basis of the qualifying property is deductible for both regular tax and AMT.[[24]](#endnote-24)

*Example:* ABC Corporation purchases $10,000 of furniture in June 2008. The furniture has a seven-year life for regular tax purposes using the 200 percent declining balance method and a seven-year life for AMT using the 150 percent declining balance method. The furniture also qualifies for a 50 percent bonus depreciation in the first year. ABC’s depreciation calculations are:

|  |  |  |  |
| --- | --- | --- | --- |
| Year | Regular Tax Depreciation | AMT Depreciation | AMT Adjustment |
| 2008 | $ 5,715 | $ 5,715 | $ 0 |
| 2009 | $ 1,224 | $ 1,224 | $ 0 |
| 2010 | $ 875 | $ 875 | $ 0 |
| 2011 | $ 624 | $ 624 | $ 0 |
| 2012 | $ 447 | $ 447 | $ 0 |
| 2013 | $ 446 | $ 446 | $ 0 |
| 2014 | $ 446 | $ 446 | $ 0 |
| 2015 | $ 223 | $ 223 | $ 0 |

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NOL Adjustments

The net operating loss (NOL) allowed under Code section 172 is added back to taxable income and replaced with the alternative tax net operating loss (ATNOL) deduction.[[25]](#endnote-25)

A taxpayer that has a NOL in a year may also, but not necessarily, have an ATNOL. For this reason, a separate calculation must be performed to determine a taxpayer’s ATNOL. This is done by starting with the NOL for regular tax purposes and increasing or decreasing this amount by the AMT adjustments and preferences in the year of the loss.[[26]](#endnote-26)

*Example:* Jack determined that he had a NOL of $175,000, which was attributable to one year when his business fell on hard times. His only AMT adjustment in that year was a $15,000 positive depreciation adjustment. Since the positive depreciation adjustment increased his AMTI, it reduces his NOL by that amount to yield an ATNOL of $160,000.

The amount of ATNOL that can be claimed as a reduction to AMTI is limited to 90 percent of the taxpayers AMTI determined without regard to the ATNOL.[[27]](#endnote-27)

Adjustments Related to Gains and Losses from the Sale of Property

Gains or losses on the sale of property are adjusted to reflect the special depreciation rules used for AMT purposes.[[28]](#endnote-28) Since the assets are depreciated using potentially different methods or lives, their adjusted basis for AMT purposes may be different than for regular tax purposes. As a result, when an asset is sold or otherwise disposed of, the gain or loss must be recomputed using the asset’s adjusted AMT basis.

*Example:* In 2003, Tire World, Inc. sold a piece of furniture for $3,000. The company originally purchased for $10,000 in 1998. At the time of the sale, their adjusted tax basis in the asset was $1,785 for regular tax purposes and $4,370 for AMT. Tire World correctly computes their regular tax gain as $1,215 ($3,000 - $1,785). For AMT purposes, Tire World realized a loss of $1,370 ($3,000 - $4,370). Tire World would report an “adjusted gain or loss” adjustment of *negative* $2,585, the difference between the adjusted basis in the asset for regular tax and AMT purposes.

Individual Adjustments

Certain adjustments apply solely to individuals:

1. *Miscellaneous itemized deductions.* When calculating AMTI, adjustments must be made for any miscellaneous itemized deduction as defined in I.R.C. §67(b).[[29]](#endnote-29)

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 Therefore, taxpayers with investment expenses, tax preparation fees, unreimbursed employee business expenses, and other miscellaneous deductions that exceed 2 percent of their adjusted gross income may not receive a benefit from these expenses if the adjustment for AMT purposes causes them to be subject to the tax.

*Example:* Joe Grant retired in early 2009 and, as a result his AGI was $45,000, much lower than usual. He paid $1,500 to have his 2008 tax return prepared, $10,000 to his investment manager for managing his investment portfolio and incurred $5,000 of unreimbursed employee business expenses. All of these expenses combined exceed 2 percent of his AGI. Joe’s itemized deduction schedule for 2009 will show that $7,500 of these expenses are deductible (the total of his expenses less 2 percent of his AGI). However, $7,500 will need to be added to his taxable income to determine his AMTI for 2009.

2. *Taxes claimed as itemized deductions*. Any taxes that are claimed as an itemized deduction (such as local property taxes) must be added back for determining AMTI.[[30]](#endnote-30) A tax that is deducted as part of a trade or business (e.g. as a sole proprietor) is not an AMT adjustment. The taxes that must be added back include itemized deductions of state, local and foreign real estate taxes, state and local personal property taxes and state, local and foreign income taxes. If a taxpayer elects to deduct sales taxes instead of state and local income taxes, the full amount of the sales tax deduction must be added back in determining AMTI.

*3. Medical expenses*. Medical expenses that exceed 7.5 percent of a taxpayer’s adjusted gross income are allowed as an itemized deduction if the taxpayer is over age sixty-five.[[31]](#endnote-31) Beginning in 2013, taxpayers under age sixty-five may deduct medical expenses that exceed 10 percent of AGI. For the purpose of determining a taxpayer’s AMTI, medical expenses are only deductible if the expenses exceed 10 percent of the taxpayer’s AGI as computed for regular tax purposes.[[32]](#endnote-32)

*Example 1:* Sam Watson is seventy years old in 2014 and has adjusted gross income of $100,000 and medical expenses of $9,000. His deductible medical expense for regular tax purposes is $1,500 ($9,000 less 7.5 percent of $100,000). When computing AMTI, Sam must add back the entire $1,500 deduction since his medical expenses do not exceed 10 percent of his AGI ($10,000).

*Example 2:* Assume Sam’s medical expenses are $12,000 instead of $9,000. His regular tax deduction is $4,500 ($12,000 less 7.5 percent of $100,000). His AMT deduction is $2,000 ($12,000 less ten percent of $100,000). The difference of $2,500 is the positive AMT adjustment that must be made in order to determine his AMTI.

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4. *Investment interest expenses.* Investment interest expense must be recomputed considering any adjustments or preference items that relate to total investment income or expense.[[33]](#endnote-33)

5. *Mortgage interest*. Home mortgage interest on indebtedness that was not incurred to acquire, construct or substantially improve the taxpayer’s principal residence or second home must be added back for computing AMTI.[[34]](#endnote-34) This would include home equity indebtedness if the proceeds of the loan were not used in the manner described above. Refinancing of previously qualifying indebtedness is allowed, but only to the extent of the amount of the qualifying indebtedness immediately before the refinancing.[[35]](#endnote-35)

6. *Refunds of taxes*. Refunds of taxes that were AMT adjustments in previous years reduce AMTI in the year of receipt.[[36]](#endnote-36)

7. *Standard deduction and personal exemptions*. If the taxpayer’s taxable income was reduced by either the standard deduction or personal exemptions, these items must be added back for AMT purposes.[[37]](#endnote-37)

8. *Incentive stock options (ISOs).* Taxpayers may defer regular tax on income resulting from the exercise of an incentive stock option (ISO).[[38]](#endnote-38) Unlike nonqualified stock options which are taxed to the extent of the value of the stock over the exercise cost, the taxation of an ISO occurs only when the stock acquired by exercise of the ISO is sold or otherwise disposed. At that time, the difference between the selling price and the amount paid for the stock when the ISO was exercised is taxed as a capital gain.

The deferral of the gain at the time of the exercise of the ISO does not apply if the taxpayer disposes of the stock within two years from the grant date of the ISO or within one year of the exercise date of the option.[[39]](#endnote-39)

For AMT purposes, the ISO does not receive the deferral treatment at the time of exercise. Instead the ISO is treated like a nonqualified stock option.[[40]](#endnote-40) This means that the value of the stock acquired at the time of exercise in excess of the exercise cost creates a positive AMT adjustment in that year. Sizeable ISO exercises are a common reason for taxpayers to be subject to the AMT.

Taxpayers who exercise ISOs must keep accurate records of the basis of their stock. For regular tax purposes, the basis will equal their exercise cost plus any transaction costs. For AMT purposes, the basis will equal the value of the stock on the date of exercise plus any transaction costs. When the stock acquired by ISO is ultimately sold, the taxpayer will reduce the AMTI in that year by the amount of the basis difference.

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*Example:* Ron Gardner exercised 1,000 ISOs of his employer, WWW, Inc. The exercise cost was $10 per option and at the time of the exercise, the stock was trading at $75 per share. Ron pays the company $10,000 and, in return, receives stock valued at $75,000. For regular tax purposes, Ron reports no income. However, he has a positive AMT adjustment of $65,000 ($75,000 - $10,000) in the year of exercise.

Three years later, Ron decides to sell 500 shares when the stock is trading at $100 per share. He will report a long-term capital gain for regular tax purposes of $45,000 ($50,000 in sale proceeds less the $5,000 basis).

For AMT purposes, his gain is only $12,500. While he has $50,000 in cash proceeds, $32,500 (half of the $65,000 AMT adjustment three years ago) of that amount was subject to AMT three years ago. In order to prevent double AMT taxation, the $32,500 will be reported as a negative AMT adjustment (entered as an adjusted gain or loss on Form 6251) in the year of the sale.

9*. AMT adjustments from pass-through entities.* Pass-through entities are required to separately identify amounts that adjustments for AMT purposes for their investors. For this reason, it is very common to find AMT adjustments for depreciation reported on an investor’s Schedule K-1.

Passive activity rules are separately applied for AMT purposes. If the net income or loss from passive activities as adjusted by any AMT items is different than the net passive activity income or loss for regular tax purposes, the difference is reported as an adjustment to AMTI.[[41]](#endnote-41)

Corporate Adjustments

The following adjustments must be made to a corporation’s taxable income:

1. A corporation must make an adjustment to its taxable income based on its “adjusted current earnings” (ACE).[[42]](#endnote-42) ACE computations are explained in detail below.

2. The charitable contributions limitation for individuals is determined based upon the taxpayer’s adjusted gross income for both regular tax and AMT purposes.[[43]](#endnote-43) However, corporations must re-determine their allowable charitable contribution for AMT purposes based upon the corporation’s AMTI, without respect to this adjustment.[[44]](#endnote-44) In fact, the instructions to Form 4626 require that this computation and adjustment be made if necessary.

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When calculating AMT, corporations must make an adjustment based on adjusted current earnings (“ACE”). ACE is defined as the AMTI for the taxable year determined with its own set of “ACE adjustments” and without the alternative tax net operating loss deduction.[[45]](#endnote-45)

The adjustments that must be made to determine a corporation’s ACE are:

1. Depreciation must be recomputed for ACE using a special set of rules for allowable method and recovery period.[[46]](#endnote-46) This creates a third set of depreciation calculations on the same assets – one for regular tax, one for AMT and now one for ACE. An asset’s placed in service date determines how the asset is treated for ACE.[[47]](#endnote-47) The adjustment applies to assets placed in service after 1989 – however, assets in service as of 1989 also need an ACE calculation.[[48]](#endnote-48)

The following table is a summary of how assets are depreciated under the ACE rules:

|  |  |
| --- | --- |
| Placed in Service Date | ACE Depreciation Treatment |
| **Taxable year beginning before 1990****(MACRS Assets)** | Basis for ACE depreciation begins with AMT basis as of the close of the last year before 1990. Depreciate using straight line method over the remainder of the property’s recovery period as determined under the alternativedepreciation system. 75 |
| **Taxable year beginning before 1990****(ACRS Assets)** | Basis for ACE depreciation beginswith regular tax basis as of the closeof the last year before 1990. Depreciate using straight line method over the remainder of the property’s recovery period as determined under the alternative depreciation system. 76 |
| **Taxable year beginning before 1990****(non-MACRS and ACRS Assets)** | No adjustments for ACE required. 77 |
| **Taxable year beginning after 1989****And on or before December 31, 1993** | Straight-line recovery over the property’s recovery period as determined under the alternative depreciation system. 78 |
|  |  |

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2. The second ACE adjustment is for items that are included in the determination of a corporation’s earnings and profits (E&P) but are excluded from AMTI.[[49]](#endnote-49) The amount of any item that is included as an adjustment may be offset by any deduction which would have been allowable in computing AMTI if the amount were included in gross income.[[50]](#endnote-50)

The ACE worksheet included in the instructions to Form 4626 contains a list of the most common E&P adjustments, such as:

*Includible Items:*

a. Tax-exempt interest excluded under Code Section 103.

b. Death benefits from life insurance contracts excluded under Code Section 101 (adjusted by the corporation’s basis in the life insurance contract).

c. Other distributions from life insurance contracts.

d. Income earned on life insurance contracts minus the part of any premium attributable to insurance coverage.

*Nondeductible Items:*

a. Deduction for dividends received, with certain exceptions for 100 percent dividend received deductions and dividends from a 20 percent owned corporation if the payor is subject to federal income tax on the earnings to which the dividend is attributable.[[51]](#endnote-51)

b. Dividends paid on certain preferred stock of public utilities deductible under Code Section 247.

c. Dividends paid to an ESOP deductible under Code Section 404(k).

d. Nonpatronage dividends that are paid and deductible under Code Section 1382(c).

*Special Items:*

a. Intangible drilling costs on productive wells of integrated oil companies must be capitalized and amortized over sixty months.[[52]](#endnote-52)

b. Amortization on circulation and organizational expenditures under Code Sections 173 and 248, respectively, is not permitted.[[53]](#endnote-53)

c. For taxpayers that account for inventory on a last-in, first-out (LIFO) basis, the excess of inventory value on a first-in, first out basis over LIFO basis is an adjustment for ACE.[[54]](#endnote-54)

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d. The installment sale method is not permitted for ACE.[[55]](#endnote-55) As a result, taxpayers with an installment sale will have a large adjustment in the first year followed by negative adjustments as payments are made on the installment sale in future years.

Adjustments are not required for discharge of indebtedness income under Code Section 108.[[56]](#endnote-56) In addition, the limit on charitable contributions is not recomputed for ACE.[[57]](#endnote-57)

Once the corporation’s ACE is determined, the ACE is compared to its pre-adjustment AMTI. If ACE exceeds pre-adjustment AMTI, the corporation must increase its AMTI by 75 percent of the excess.[[58]](#endnote-58)

If ACE is less than pre-adjustment AMTI, the corporation may reduce its AMTI by 75 percent of the difference.[[59]](#endnote-59) However, the potential negative adjustment is limited to the excess of the aggregate positive ACE adjustments made to AMTI in prior years over the aggregate negative ACE adjustments made to AMTI in prior years.[[60]](#endnote-60)

# What are AMT Preferences?

The following tax preference items must be *added* to a taxpayer’s taxable income in computing AMTI. As discussed above, tax preference items may only increase AMTI – negative tax preference items are not permitted.

* *Depletion.* The excess of the deduction for depletion over the adjusted basis of the property at the end of the taxable year.[[61]](#endnote-61)
* *Intangible drilling costs.* The amount by which excess intangible drilling costs are greater than 65 percent of the net income of the taxpayer’s oil, gas, and geothermal properties for the tax year.[[62]](#endnote-62)

The excess intangible drilling costs are the excess of the intangible drilling and development costs paid or incurred in connection with oil, gas and geothermal wells over the amount that would have been allowable for the taxable year if such costs had been capitalized and straight line recovery of intangibles (over 120 months) had been used with respect to such costs.[[63]](#endnote-63)

* *Tax-exempt interest on private activity bonds.* Any tax-exempt interest earned on specified private activity bonds must be added to AMTI. The amount of interest to be added back is reduced by any deductions which would have been allowable if the tax-exempt interest was includible in gross income for regular tax purposes.[[64]](#endnote-64)

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A “specified private activity bond” is any private activity bond which is issued after August 7, 1986.[[65]](#endnote-65) Private activity bonds are covered by I.R.C. §141 and include any bonds that meet either (1) the “private business use” test and the “private security or payment” test or (2) the “private loan financing” test.

A bond is identified as a private activity bond at the time of its issue. Because of the inclusion of the interest paid on such bonds in the AMTI of its holders, these bonds typically will pay a higher yield than pure tax-exempt municipal bonds.

Investors in mutual funds that earn some tax-exempt interest should watch for the percentage of tax-exempt income that was earned on private activity bonds. The proportionate share of the tax-exempt income earned on such bonds must be added to AMTI.[[66]](#endnote-66)

* *Gains on small business stock.* Gains of certain small business stock that is held for more than five years qualify for a 50 percent exclusion from taxation.[[67]](#endnote-67) Small business stock must meet the following requirements:

a. It must have been issued after August 10, 1993.[[68]](#endnote-68)

b. The taxpayer must be the original holder of the stock and the stock must have been acquired in exchange for money or other property (not including stock) or as compensation for services performed.[[69]](#endnote-69)

c. The corporation must be an active business.[[70]](#endnote-70)

d. The corporation must be a qualified small business.[[71]](#endnote-71) That is, it must be a domestic C corporation with aggregate gross assets of less than $50,000,000.[[72]](#endnote-72)

The amount of the excluded gain that must be added back to AMTI is 7 percent.[[73]](#endnote-73)

*Example:* Jack Armstrong realized a gain of $300,000 on the sale of Section 1202 stock on June 1, 2014. Accordingly, Jack excludes $150,000 of the gain for regular tax purposes. Jack must add back $10,500 ($150,000 x 7 percent) as a preference item when determining his AMT.

# AMT Exemption for Small Corporations

The Taxpayer Relief Act of 1997 created an exemption from the AMT for certain “small” corporations. The exemption applies to qualifying corporations with tax years beginning after 1997.

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In order to qualify for the exemption, a corporation must look to its three taxable years prior to the taxable year in question.[[74]](#endnote-74) The average gross receipts for this three-year period must not exceed $7.5 million.[[75]](#endnote-75)

*Example:* Smallville, Inc. needs to determine if it can qualify for the AMT exemption in 2013. They expanded operations in the prior year and their revenue doubled. The company reviews their prior three years of revenue and find that for 2010, 2011, and 2012 their gross receipts were $6 million, $6 million, and $12 million, respectively. Their average gross receipts for the preceding three-year period is $8 million. Therefore, Smallville no longer qualifies for the small corporation AMT exemption beginning in 2013.

A special exception applies for new corporations. Any first year corporation is automatically exempted from the AMT regardless of the amount of gross receipts derived from operations.[[76]](#endnote-76) For a new corporation’s second year, the exemption will only apply if the corporation’s gross receipts in the first year were no more than $5 million.[[77]](#endnote-77) After a corporation’s second year, the corporation must meet the $7.5 million average gross receipts test. Gross receipts for any taxable period of less than twelve months must be annualized when applying these tests.[[78]](#endnote-78)

If a qualifying small corporation ceases to be a small corporation because its average gross receipts exceed the allowable limits, the corporation will be subject to the AMT for that and all future years. The first day of the taxable year during which the taxpayer ceases to be a small corporation is the “change date.”[[79]](#endnote-79) The AMT is then computed with the following modifications:

1. The depreciation adjustment is computed only on property placed in service after the change date.[[80]](#endnote-80)

2. The mining and exploration adjustment is applied only to costs paid or incurred after the change date.[[81]](#endnote-81)

3. The long-term contract adjustment is applied only to contracts entered into after the change date.[[82]](#endnote-82)

4. The adjustment for alternative tax net operating loss deduction must be computed as of the change date.[[83]](#endnote-83)

5. The limitation on the allowance of negative adjustments to AMTI based on adjusted current earnings will apply only to those “prior taxable years” that begin on or after the change date.[[84]](#endnote-84)

6. The depreciation adjustment for computing ACE does not apply.[[85]](#endnote-85)

7. The earnings and profits adjustment and depletion must be computed as of the change date.[[86]](#endnote-86)

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# Foreign Tax Credit

A credit for foreign taxes paid or accrued is permitted as a reduction to the tentative minimum tax for individuals and corporations. The credit is computed in the same manner as it is for regular tax purposes except it is based on the tentative minimum tax before the credit. Taxpayers claiming the credit must adjust taxable income by the adjustments and preferences of Code sections 56, 57 and 58.[[87]](#endnote-87)

# Credits against Regular Tax

There are a number of credits that are available to reduce a taxpayer’s regular tax liability. However, a taxpayer may be limited in the amount of credits that may be used to offset their regular tax liability based on the AMT for the year.

Currently, only the adoption credit, child tax credit, retirement savings contribution credit, and certain energy efficiency credits may be used to offset both a taxpayer’s regular tax and AMT. Other credits may offset regular tax only.

A taxpayer that has business tax credits may not use the credits to offset their AMT in a given year. The general business credit of a taxpayer is limited to the taxpayer’s net regular tax (net of nonrefundable personal credits, foreign tax credit, and certain other rarely used credits) plus AMT, less the larger of (1) tentative minimum tax or (2) 25 percent of the amount by which the net regular tax exceeds $25,000.[[88]](#endnote-88)

*Example:* Jessica’s net regular tax liability for 2014 was $50,000. Her tentative minimum tax was $47,000. She also received a $5,000 general business credit from one of her partnership investments. She is permitted to claim $3,000 of the credit against her 2014 tax liability and thereby reduce her regular tax to $47,000. The remaining $2,000 may be carried forward to future years subject to carryforward limitations.

# Minimum Tax Credit

Taxpayers that are caught by the AMT may have the opportunity to recoup some of that payment in future years through the minimum tax credit (MTC).[[89]](#endnote-89) For individuals, the MTC is created by AMT that is attributable to *deferral* adjustments or preferences. “Deferral adjustments and preferences” are adjustments or preferences that are made merely because of the timing of particular tax item. On the other hand, AMT that is attributable to *exclusion* adjustments and preferences does not create a MTC. Exclusion adjustments and preferences are ones that would have to be made regardless of timing of the particular tax item.

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It is easier to list the exclusion adjustments and preferences, keeping in mind that all other adjustments and preferences are of the deferral type and will add to a taxpayer’s MTC:[[90]](#endnote-90)

* Taxes
* Medical expenses
* Certain residential interest expense
* Miscellaneous itemized deductions
* Standard deduction
* Personal exemptions
* Excess depletion
* Tax-exempt interest from private activity bonds
* Applicable add back for the Section 1202 exclusion for gain from the sale of small business stock

For individuals, the MTC amount is the difference between the taxpayer’s actual AMT and the AMT that would have been owed if only the exclusion adjustments and preferences were considered.[[91]](#endnote-91) The MTC is available to reduce a taxpayer’s regular tax liability only if the taxpayer is not subject to the AMT. Obviously, an MTC credit will not be available to the taxpayer in the year it is generated. However, any unused MTC is carried forward to offset future regular tax liability in years that the taxpayer is not subject to the AMT. Note that taxpayer’s may only use a carried-forward MTC to offset regular tax liability to the extent that their regular tax liability exceeds their AMT tax liability. This restriction means that it can take many years to completely use a significant MTC.

Individuals report the MTC on Form 8801. Figure 2 illustrates the calculation and use of a hypothetical MTC credit for an individual.

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|  |
| --- |
| Figure 2 |
| Example of MTC Credit Calculation and Use |
| In 2013, Jerry exercised a number of ISOs and, as a result, paid $25,000 of AMT. The only other adjustment he had for AMT purposes was his standard deduction and personal exemption. When preparing his 2014 individual income tax return, Jerry must determine the amount of the MTC available to him. He does this by using Form 8801 to calculate the value of his 2013 deferral adjustments (here, his standard deduction and personal exemption). After completing Form 8801, Jerry realizes that the deferral adjustments increased his 2013 AMT by $22,000. This amount becomes Jerry's MTC. Because Jerry was subject to the AMT in 2013, the entire MTC credit will be carried forward to be used in subsequent years. |
| **Year** | **MTC available** | **Regular tax Liability** | **AMT liability** | **Amount of MTC used to offset regular tax liability** |
| 2014 | $22,000 | $25,000 | $20,000 | $5,000 |
| 2015 | $17,000 | $25,000 | $24,000 | $1,000 |
| 2016 | $16,000 | $30,000 | $22,000 | $8,000 |
| 2017 | $8,000 | $30,000 | $25,000 | $5,000 |
| 2018 | $3,000 | $32,000 | $28,000 | $3,000 |

Unlike what is required for individuals, The MTC for corporations is determined without making any adjustments to the AMT paid in prior years.[[92]](#endnote-92) If a corporation pays the AMT in a prior year, the full amount of the AMT is available as a MTC in subsequent years offset the entity's regular tax liability to the extent that it exceeds the AMT liability. Corporations use Form 8827 to determine the MTC.

*Example:* Palace Amusements paid $5,000 of AMT in 2013. In 2014, the company's regular tax liability, before the MTC, was $55,000. The company's tentative minimum tax was $47,000. Since the utilization of the MTC against regular tax does not reduce the tax below the company's tentative minimum tax, the full amount of the MTC is allowed in 2014. The company's net tax liability for 2014 is reduced to $50,000.

*Refundable MTC.* Beginning in 2007 and ending with the 2012 tax year, the Tax Relief and Healthcare Act of 2007 allowed taxpayers with long-term unused minimum tax credits an opportunity to benefit from the minimum tax credit sooner. This “Refundable Minimum Tax Credit” was equal to the greater of $5,000 or 20 percent of the long-term unused MTC for the year. The primary purpose of creating this provision was to give relief to the many taxpayers

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who exercised incentive stock options in prior years and, for one reason or another, have not benefited from the existing MTC rules. This exception expired is no longer applicable for current tax returns.

1. Quick Facts: Alternative Minimum Tax; www.taxpolicycenter.org. [↑](#endnote-ref-1)
2. I.R.C. §55(b)(1)(A). [↑](#endnote-ref-2)
3. I.R.C. §55(b)(3). [↑](#endnote-ref-3)
4. I.R.C. §55(b)(2). [↑](#endnote-ref-4)
5. I.R.C. §55(b)(2)(A). [↑](#endnote-ref-5)
6. I.R.C. §55(b)(2)(B). [↑](#endnote-ref-6)
7. I.R.C. §55(d)(1). [↑](#endnote-ref-7)
8. I.R.C. §55(d)(3). [↑](#endnote-ref-8)
9. I.R.C. §55(d)(3). [↑](#endnote-ref-9)
10. I.R.C. §55(b)(2). [↑](#endnote-ref-10)
11. I.R.C. §55(b)(2)(A). [↑](#endnote-ref-11)
12. I.R.C. §55(b)(2)(B). [↑](#endnote-ref-12)
13. I.R.C. §56(g)(1). [↑](#endnote-ref-13)
14. I.R.C. §56(g)(2). [↑](#endnote-ref-14)
15. I.R.C. §56(g)(2)(B). [↑](#endnote-ref-15)
16. I.R.C. §55(d)(2). [↑](#endnote-ref-16)
17. I.R.C. §55(d)(3). [↑](#endnote-ref-17)
18. See I.R.C. §1561(a)(3) for groups defined under I.R.C. §1563(a). [↑](#endnote-ref-18)
19. I.R.C. §1561(a). [↑](#endnote-ref-19)
20. I.R.C. §56(a)(1). [↑](#endnote-ref-20)
21. 1987-2 C.B. 674. [↑](#endnote-ref-21)
22. I.R.C. §56(a)(1)(A). [↑](#endnote-ref-22)
23. I.R.C. §168(k)(2)(G). [↑](#endnote-ref-23)
24. Rev. Proc. 2002-33, 2002-1 CB 963. [↑](#endnote-ref-24)
25. I.R.C. §56(a)(4). [↑](#endnote-ref-25)
26. I.R.C. §56(d)(2). [↑](#endnote-ref-26)
27. I.R.C. §56(d)(1)(A). [↑](#endnote-ref-27)
28. I.R.C. §56(a)(6). [↑](#endnote-ref-28)
29. I.R.C. §56(b)(1)(A)(i). [↑](#endnote-ref-29)
30. I.R.C. §56(b)(1)(A)(ii). [↑](#endnote-ref-30)
31. I.R.C. §213(a). [↑](#endnote-ref-31)
32. I.R.C. §56(b)(1)(B). [↑](#endnote-ref-32)
33. I.R.C. §56(b)(1)(C). [↑](#endnote-ref-33)
34. I.R.C. §56(e)(1)(A). [↑](#endnote-ref-34)
35. I.R.C. §56(e)(1)(B). [↑](#endnote-ref-35)
36. I.R.C. §56(b)(1)(D). [↑](#endnote-ref-36)
37. I.R.C. §56(b)(1)(E). [↑](#endnote-ref-37)
38. I.R.C. §421(a). [↑](#endnote-ref-38)
39. I.R.C. §422(a)(1). [↑](#endnote-ref-39)
40. I.R.C. §56(b)(3). [↑](#endnote-ref-40)
41. I.R.C. §58(b). [↑](#endnote-ref-41)
42. I.R.C. §56(c)(1). [↑](#endnote-ref-42)
43. I.R.C. §170(b)(1). [↑](#endnote-ref-43)
44. TAM 9320003. [↑](#endnote-ref-44)
45. I.R.C. §56(g)(3). [↑](#endnote-ref-45)
46. I.R.C. §56(g)(4)(A)(ii). [↑](#endnote-ref-46)
47. I.R.C. §56(g)(4)(A)(iii). [↑](#endnote-ref-47)
48. I.R.C. §56(g)(4)(A)(i). [↑](#endnote-ref-48)
49. I.R.C. §56(g)(4)(B)(i)(I). [↑](#endnote-ref-49)
50. I.R.C. §56(g)(4)(B)(i)(II). [↑](#endnote-ref-50)
51. I.R.C. §56(g)(4)(C)(ii). [↑](#endnote-ref-51)
52. I.R.C. §56(g)(4)(D)(i). [↑](#endnote-ref-52)
53. I.R.C. §56(g)(4)(D)(ii). [↑](#endnote-ref-53)
54. I.R.C. §56(g)(4)(D)(iii). [↑](#endnote-ref-54)
55. I.R.C. §56(g)(4)(D)(iv). [↑](#endnote-ref-55)
56. I.R.C. §56(g)(4)(B)(i). [↑](#endnote-ref-56)
57. I.R.C. §56(g)(4)(I). [↑](#endnote-ref-57)
58. I.R.C. §56(g)(1). [↑](#endnote-ref-58)
59. I.R.C. §56(g)(2). [↑](#endnote-ref-59)
60. I.R.C. §56(g)(2)(B). [↑](#endnote-ref-60)
61. I.R.C. §57(a)(1). [↑](#endnote-ref-61)
62. I.R.C. §57(a)(2)(A). [↑](#endnote-ref-62)
63. I.R.C. §§57(a)(2)(B) and 57(b)(1). [↑](#endnote-ref-63)
64. I.R.C. §57(a)(5)(A). [↑](#endnote-ref-64)
65. I.R.C. §57(a)(5)(C)(i). [↑](#endnote-ref-65)
66. I.R.C. §57(a)(5)(B). [↑](#endnote-ref-66)
67. I.R.C. §1202(a)(1). [↑](#endnote-ref-67)
68. I.R.C. §1202(c)(1). [↑](#endnote-ref-68)
69. I.R.C. §1202(c)(1)(B). [↑](#endnote-ref-69)
70. I.R.C. §1202(c)(2). [↑](#endnote-ref-70)
71. I.R.C. §1202(c)(1)(A). [↑](#endnote-ref-71)
72. I.R.C. §1202(d). [↑](#endnote-ref-72)
73. I.R.C. §57(a)(7). [↑](#endnote-ref-73)
74. I.R.C. §55(e)(1)(A). [↑](#endnote-ref-74)
75. *Ibid.* [↑](#endnote-ref-75)
76. I.R.C. §55(e)(1)(C). [↑](#endnote-ref-76)
77. I.R.C. §55(e)(1)(B). [↑](#endnote-ref-77)
78. I.R.C. §55(e)(1)(D). [↑](#endnote-ref-78)
79. I.R.C. §55(e)(4). [↑](#endnote-ref-79)
80. I.R.C. §55(e)(2)(A). [↑](#endnote-ref-80)
81. I.R.C. §55(e)(2)(B). [↑](#endnote-ref-81)
82. I.R.C. §55(e)(2)(C). [↑](#endnote-ref-82)
83. I.R.C. §55(e)(2)(D). [↑](#endnote-ref-83)
84. I.R.C. §55(e)(2)(E). [↑](#endnote-ref-84)
85. I.R.C. §55(e)(2)(F). [↑](#endnote-ref-85)
86. I.R.C. §55(e)(2)(G). [↑](#endnote-ref-86)
87. I.R.C. §59(a)(1). [↑](#endnote-ref-87)
88. I.R.C. §38(c). [↑](#endnote-ref-88)
89. I.R.C. §53(a). [↑](#endnote-ref-89)
90. I.R.C. §53(d)(1)(B)(ii). [↑](#endnote-ref-90)
91. I.R.C. §53(d)(1)(B)(i). [↑](#endnote-ref-91)
92. I.R.C. §53(d)(1)(B)(iii). [↑](#endnote-ref-92)