

The AMT—Affecting More and More Taxpayers

It seems that nowadays, an increasing number of middle class taxpayers are being affected by the Alternative Minimum Tax (AMT). This is rather interesting, considering the AMT was originally intended to prevent taxpayers with substantial incomes from avoiding tax liability through the use of tax shelters.

On its most basic level, the AMT is a minimum amount of income tax that must be paid by each taxpayer. The AMT is calculated under rules that are, in many ways, quite different from those used to calculate your ordinary income tax liability. The AMT can serve to increase your federal income taxes if your federal income tax liability, as calculated under AMT rules, is greater than your ordinary federal income tax liability as calculated without regard to the AMT rules.

Congress implemented the AMT because too many people were using tax shelters, income tax deductions, and tax credits. As a result, some individuals often paid little or no income tax. So, in recent years, Congress has continued to modify the Alternative Minimum Tax. Now, more than just the wealthy are becoming affected. What does that mean if you are in the middle class?

Since significant modifications were made to the AMT in 1986, there have been changes in the economy. For instance, healthcare costs have increased beyond expectations; home equity buildup has allowed homeowners to obtain substantial equity loans; and state and local taxes, in some cases, have remained at significant levels. All these changes relate to the AMT and to your income taxes. Consequently, if you have tax deductions, tax-exempt income, and tax credits, you may discover that you are subject to the AMT.

Here's a general overview of some of the more common differences between AMT rules and ordinary income tax rules, that can increase a middle class taxpayer's chances of being subject to the AMT:

1. **Medical and dental expenses** that are greater than 10% of your adjusted gross income (AGI) are deductible for purposes of the AMT. However, medical expenses are deductible for ordinary income tax purposes to the extent they exceed 7.5% of AGI. This difference in tax treatment can make you more likely to be subject to AMT if you have high medical expenses for which you are taking a deduction against your regular taxable income.
2. **Taxes you paid** to your state and local governments are nondeductible for AMT purposes. However, these items are deductible from your regular taxable income. This includes real estate, personal property, and any other tax. Therefore, if you live in New York, Massachusetts, California, or a state with a significant income tax, your chances of being affected by the AMT are increased.
3. **Mortgage interest you** paid and deducted may not be deductible for the AMT even though it is generally deductible from your regular taxable income. If you obtained a home equity loan that was not used to buy, build, renovate, or improve your home, the interest is nondeductible. Once again, the likelihood that you could be subject to AMT is increased.
4. **Employers often use incentive stock options** as part of an employee's compensation. As an employee, you may have been given a qualifying stock option to purchase your company's stock in the future. Ordinarily, you would pay no income tax at the time you receive the stock option or at the time you convert the option to the stock and receive a profit. For ordinary tax purposes, tax is deferred until the stock is sold. However, for AMT purposes, the difference between the **fair market value (FMV)** of the stock and the amount paid for the stock due to the option is generally considered taxable income when the option is exercised. This may make a big difference for taxpayers with stock options, and may significantly increase their chances of being subject to AMT when they exercise these options.
5. **Many tax credits and deductions** are often not used when calculating the AMT. In addition, the standard deduction is also not considered.

Under the Tax Increase Prevention and Reconciliation Act (TIPRA), the 2006 AMT exemption amounts were raised to \$62,550 for married couples filing jointly and \$42,500 for single filers. Under the new law, taxpayers also may use all nonrefundable personal credits to offset AMT liability. According to the Urban-Brookings Tax Policy Center (TPC, 2006), 3.6 million filers paid the AMT in 2005, but 18.9 million taxpayers would have been hit with the AMT in 2006 without additional relief. Without further reform, the AMT exemption amounts will drop to \$45,000 for joint filers and \$33,750 for single filers in 2007.

If deductions, exemptions, or ISOs result in a substantial reduction of your ordinary income taxes, you should consult with an accountant to check your alternative minimum tax status. You may be able to take steps now to reduce your exposure and plan ahead for next year's tax return.