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White Paper

*Alternative Minimum Tax*

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# Alternative Minimum Tax

## What is the alternative minimum tax (AMT)?

The alternative minimum tax (AMT) is an extra tax that certain taxpayers must pay in addition to their regular income tax. The purpose of the AMT is to prevent taxpayers with substantial income from using tax "loopholes" (such as certain exclusions, deductions, and credits) to pay little or no tax. Through the AMT, these taxpayers must pay at least a minimum amount of tax.

The AMT is based on an alternative set of rules for calculating income tax. A separate accounting method is used to govern the recognition and timing of income and expenses. If you're subject to the AMT, you must compute both your regular tax and your AMT. If your AMT liability is greater than your regular income tax liability, the difference is reported as an additional tax on your federal income tax return. In effect, you're liable for either the AMT or the regular income tax, whichever amount is higher.

## How do you know if you're subject to the AMT?

The IRS provides a worksheet in the Form 1040 and 1040A instructions to help you determine if the AMT applies to you. If it does, you must complete IRS Form 6251 to figure out how much tax you owe. You may have to pay the AMT if your regular taxable income (before subtracting your personal exemptions), plus certain AMT adjustments and preferences, is more than a specified exemption amount.

**Tip:** Corporations must use Form 4626 to compute the AMT. Estates and trusts must use Schedule I of Form 1041. Different rules may apply.

Be on the alert: Increasing numbers of middle-income taxpayers are subject to the AMT, and you may be included. There are several reasons for this expansion. Regular tax rates have dropped without a corresponding drop in the AMT rates, the AMT exemption is not indexed for inflation, and some middle-income taxpayers simply have numerous dependency exemptions and substantial deductions.

Although several factors could give rise to AMT liability, be on the lookout for the following issues on your tax return:

- Large numbers of personal exemptions
- Large amounts of miscellaneous itemized deductions
- Large amounts of state and local taxes paid
- Large capital gains
- Large deductible medical expenses
- The exercising of a large incentive stock option

Such issues are treated differently for AMT purposes and could trigger AMT liability for "ordinary" taxpayers. For example, although a personal exemption reduces your regular income tax liability,

personal exemptions are ignored when computing your AMT. That brings us to AMT preferences and adjustments.

## What are AMT preferences and adjustments?

Certain tax benefits available under the regular tax system--such as miscellaneous itemized deductions and the deduction of state income taxes paid--are reduced or eliminated when computing your alternative minimum taxable income (AMTI). Therefore, these tax benefit items--called AMT preferences and adjustments--can generate AMT liability. You must list these tax preferences and adjustments on Form 6251, and they must be added to or subtracted from your regular taxable income (before personal exemptions) to arrive at your AMTI.

For instance, medical expenses are normally deductible only to the extent that they exceed 7.5 percent of your adjusted gross income (AGI). However, when computing your AMTI, medical expenses are deductible only to the extent that they exceed 10 percent of your AGI. Therefore, if you took a deduction for medical expenses on Schedule A of your Form 1040, you must recalculate that deduction using the 10 percent figure for AMT purposes.

The following chart shows how tax benefit items are treated under the regular tax system and under the AMT system.

Item	Regular income tax--Form 1040	Alternative minimum tax--Form 6251
<b>Standard deduction</b>	Subtracted from AGI.	Not allowed. If used on Form 1040, add back full amount.
<b>Medical and dental expenses</b>	Amounts over 7.5% of AGI are deductible.	Amounts over 10% of AGI are deductible. Add back 2.5% of AGI or actual amount of medical and dental expenses deducted on Schedule A, whichever is less.
<b>Taxes</b>	State income tax, real estate tax, etc., are deductible.	Not allowed. Add back any taxes deducted on Schedule A.
<b>Home mortgage interest</b>	Deductible (subject to limits), if loan secured by home.	Interest deduction is allowable only on loans used to buy, build, or improve your main or second home. Interest deduction on refinanced amounts in excess of the original mortgage is not allowed. Add back any amount of disallowed interest deduction.

Item	Regular income tax--Form 1040	Alternative minimum tax--Form 6251
Refund of taxes	Added to income if previously deducted.	Tax refunds are not included in income. Enter negative amount on Form 6251.
Investment interest	Interest expense relating to tax-exempt interest income is not deductible.	Interest expense relating to tax-exempt private activity bonds is deductible, subject to limits.
Depreciation after 1986	Choice between General Depreciation System and Alternative Depreciation System.	Special depreciation rules must be applied. Consult a tax advisor for more details.
Miscellaneous itemized deductions subject to 2% AGI limitation	Amount that exceeds 2% limit is deductible on Schedule A.	Not allowed. Add back any amounts deducted on Schedule A.
Adjusted gain or loss	Gain or loss from the sale of property is generally included in taxable income.	Gain or loss from the sale of property must be recalculated for AMT if adjusted tax basis of property was affected by AMT adjustments such as depreciation, circulation costs, research costs, mining development costs, or the AMT rules affecting incentive stock options. (This adjustment can be positive or negative.)
Incentive stock options	Exercise of a qualified incentive stock option is generally not a taxable event.	Difference between amount paid to acquire the stock under the incentive stock option and the fair market value of the stock must be added for AMT unless the stock is sold later in same year.
Passive activities	Loss limited to passive activity income.	Gains or losses must be recalculated by taking into account all AMT adjustments and preferences that apply (including any recomputed passive activity loss carryforwards).
Beneficiaries of estates and trusts	Amounts shown on Schedule K-1 (Form 1041) are reported on beneficiary's federal income tax return.	An adjustment for the estate's or trust's AMT items will be shown on Schedule K-1, Form 1041.

Item	Regular income tax--Form 1040	Alternative minimum tax--Form 6251
Tax-exempt interest from private activity bonds issued by state or local governments after August 7, 1986	Exempt from income tax. Allocable interest expense not deductible.	Amount of income must be included for AMT. Income may be reduced by allocable expenses that were not deductible on Form 1040.*
Circulation expenditures	Expenses incurred to increase the circulation of a newspaper, magazine, or other periodical are generally deductible in the year incurred or paid.	Must be capitalized and amortized over three years. Add back difference between current deduction and amount allowed with three-year amortization.
Depreciation prior to 1987	Accelerated or straight-line depreciation available.	Amount of depreciation in excess of amount allowed under straight-line method must be added back for AMT. Consult a tax advisor for more details.
Long-term contract	Depends on accounting method.	Generally must use percentage of completion method. There are certain exceptions for home construction contracts.
Research and experimental costs	Generally may be deducted, amortized, or capitalized.	Must be amortized over 10 years. Add back difference between current deduction and amortized amount allowed.
Intangible drilling costs	Deductible currently or may elect to write off over 60 months.	If 60-month write-off is not elected, costs in excess of 65% of net income from well must be written off over 120 months. Enter difference between amount deducted and amount allowed.
At-risk limitation	Loss limited to amounts at risk.	Gains or losses must be recalculated by taking into account all AMT adjustments and preferences that apply.
Mining costs	Deductible currently or may elect to write off over 10 years.	Must be capitalized and amortized over 10 years. Enter difference between current deduction and amortized amount allowed.

Item	Regular income tax--Form 1040	Alternative minimum tax--Form 6251
<b>Pollution control facilities</b>	Basis of certain assets can be amortized over 60 months.	Basis of certain assets must be depreciated under the Modified Accelerated Cost Recovery System for facilities placed in service after 1998 and the Alternative Depreciation System for facilities placed in service before 1999. Enter difference between amortized deduction and depreciation deduction allowed.
<b>Tax shelter farm activities</b>	Loss may be limited under passive or at-risk rules.	Gains or losses are recalculated for AMT purposes only if not a passive activity.
<b>Depletion</b>	Depletion deduction allowed.	Deduction must be recalculated using allowable AMT income and deductions. Limited to basis recalculated under AMT rules.
<b>Patronage dividend</b>	May be taxable or nontaxable.	If taxable, cooperative will provide taxpayer with information on how much to include as an AMT adjustment.
<b>Gain from qualified small business stock</b>	50% capital gain exclusion for Section 1202 stock.	7% of excluded gain is added back.

\* For bonds issued after July 30, 2008, the Housing and Economic Recovery Act of 2008 provides that tax-exempt interest earned on the following instruments is not a preference item for AMT purposes:

- exempt facility bonds issued as part of an issue 95 percent or more of the net proceeds of which are used to provide qualified residential rental projects
- qualified mortgage bonds
- qualified veterans' mortgage bonds

### Dual basis assets and capital gains

In some cases, an asset may have one basis for regular income tax purposes and a different basis (usually higher) for AMT purposes. (Generally--but not always--your "basis" in an asset is what you paid for it, plus or minus certain adjustments. Your adjusted basis is the portion of the asset that shouldn't be taxed when you sell the asset.) When there's a tax basis difference, the AMT capital gain or loss won't be the same as the regular capital gain or loss. See the "adjusted gain or loss" section of the above table.

For instance, exercising an incentive stock option isn't usually a taxable event for regular income tax purposes. However, you may have to report income for AMT purposes when you exercise an incentive stock option. The difference between your exercise price and the fair market value of the stock on the exercise date is considered an adjustment for AMT purposes. So, you might have to pay AMT in the year you exercise an incentive stock option. However, your AMT basis in the stock is increased by the amount of the adjustment. This could create a smaller capital gain when you sell the stock. If you overlook this basis adjustment, you might end up paying too much tax.

## How do you calculate your AMT?

Individuals make their AMT calculations on IRS Form 6251. Although this form looks complicated, calculating your AMT really involves three major steps.

### Compute your alternative minimum taxable income

Essentially, the starting point is line 37 of your Form 1040, which is your AGI after deducting your standard deduction or itemized deductions, but before subtracting your personal exemptions. (You can also think of this as your taxable income less personal exemptions.) This amount (from line 37) is then increased by your total tax benefit items (i.e., tax preferences and adjustments) as calculated on Form 6251. The result is your AMTI.

### Subtract your AMT exemption amount

You are entitled to an AMT exemption amount. This exemption was designed to prevent the AMT from applying to taxpayers with modest incomes. The amount of your exemption is phased out as your AMTI reaches higher levels. The exemption is subtracted from your AMTI to determine the amount of your AMTI that is subject to tax at the AMT rates.

The AMT exemption amounts for 2008 are:

Filing status	Maximum exemption	AMTI exemption phaseout threshold
Married filing jointly or qualifying widow(er)	\$45,000	\$150,000
Single or head of household	\$33,750	\$112,500
Married filing separately	\$22,500	\$75,000

The AMT exemption amounts for 2007 are:

Filing status	Maximum exemption	AMTI exemption phaseout threshold
Married filing jointly or qualifying widow(er)	\$66,250	\$150,000
Single or head of household	\$44,350	\$112,500
Married filing separately	\$33,125	\$75,000

Your exemption phases out if your AMTI exceeds the thresholds indicated above. More specifically, your exemption is reduced by 25 percent of the amount by which your AMTI exceeds the applicable threshold for your filing status.

**Tip:** In 2008, the AMT exemption amount is limited for children under the kiddie tax threshold age to the lesser of \$33,750 (\$44,350 in 2007) or the child's earned income plus \$6,400 (\$6,300 in 2007).

### Multiply the remainder by the AMT rate

After subtracting your exemption amount, multiply the remainder by the applicable AMT rate. This tax rate is:

- 26 percent on amounts up to \$175,000 (\$87,500 for taxpayers filing as married filing separately)
- 28 percent on amounts above \$175,000 (\$87,500 for taxpayers filing as married filing separately)

Generally, the resulting figure is your tentative minimum tax (TMT). Compare your TMT with your regular income tax. If the regular tax is higher, you don't owe any AMT. But if the regular tax is lower, the difference between the two taxes is the amount of AMT you must pay in addition to your regular tax (if any).

**Example(s):** Your regular income tax is \$50,000. When you calculate your tax using the AMT rules, you come up with \$62,000. Therefore, you must pay \$12,000 of AMT in addition to the \$50,000 of regular income tax.

### Can you reduce your AMT liability with personal tax credits?

You can offset your AMT liability with personal refundable tax credits including the earned income credit and the refundable portion of the child tax credit. For tax year 2007, you can also offset AMT liability with nonrefundable personal tax credits, including (among others):

- The adoption tax credit
- The child and dependent care credit
- Nonrefundable portion of child tax credit
- The tax credit for the elderly or the disabled
- The Hope credit and Lifetime Learning credit
- The tax credit for IRAs and retirement plans ("savers" credit)
- Energy-saving credits
- Certain homeowner credits

However, for tax year 2008 and thereafter, taxpayers can only claim the adoption credit, the child tax credit, and the saver's credit against the AMT without limitation. Taxpayers can claim other personal nonrefundable tax credits only to the extent that their regular tax liability exceeds their tentative minimum tax.

**Tip:** General business tax credits generally cannot offset AMT liability. However, under the Housing and Economic Recovery Act of 2008, the low-income housing credit and the rehabilitation credit can offset AMT to the extent the credits are attributable to expenditures properly taken into account for periods after December 31, 2007.

## Can you avoid the AMT?

Your ability to dodge the AMT depends on your individual financial circumstances. In general, though, you might want to defer any deductions and tax benefits that trigger the AMT if you think you'll be subject to it this year. You might also want to accelerate income so your deductions will be within the AMT limits. Because AMT planning is complex, you should consult a tax advisor.

**Tip:** Keep the AMT in mind if you pay estimated taxes. If you believe the AMT may be an issue for you this year, a tax professional or certain tax preparation software may help you calculate the proper amount of estimated tax.

## What is the AMT credit for prior year minimum tax?

If you paid AMT last year, you may be entitled to an AMT credit this year. AMT preferences and adjustments can be divided into two categories: permanent differences ("exclusion items") and timing differences. Permanent differences involve items that can be deducted for regular income tax purposes, but not for AMT purposes. Miscellaneous itemized deductions fall into this category. Timing differences involve items--such as depreciation--that are deducted differently for AMT and regular tax purposes. Usually, timing items allow you to delay reporting income. If you paid AMT last year because of timing differences, you can claim a credit (the minimum tax credit) against your regular income tax this year for the amount of AMT attributable to those timing differences.

## Calculating the credit

Your current year credit is figured on IRS Form 8801, and you'll need to refer to last year's Form 6251. Basically, you use information from last year's Form 6251 to calculate a TMT on last year's exclusion items. This TMT is then reduced by last year's regular tax to arrive at a net minimum tax on exclusion items, indicated in Part 1 of Form 8801.

The amount from Part 1 is then subtracted from last year's AMT to arrive at a minimum tax credit on deferral (timing) items. Credit carryovers from previous years are added to this amount. The credit allowed for this year is the excess of current year regular tax over current year AMT.

**Example(s):** Assume you had \$7,000 of AMT credit available from year one. In year two, your regular tax liability is \$36,000. Your tax calculated under the AMT rules is \$31,000. You don't have to pay AMT in year two because your regular tax is higher than the tax calculated under the AMT rules. In addition, you are allowed to claim \$5,000 of AMT credit in year two (\$36,000 minus \$31,000), reducing your regular tax to \$31,000.

**Tip:** The amount of AMT resulting from timing difference items may be carried forward indefinitely and is available as a credit against your regular tax liability in future years. Form 8801 allows you to compute the amount of AMT that results from such items and is used to carry the credit forward. However, since the AMT credit may only be applied against your regular tax liability, it generally may not be used in any year in which you are liable for AMT.

## "AMT refundable credit amount"

The Tax Relief and Health Care Act of 2006 and the Tax Increase Prevention Act of 2007 provide an AMT provision that expands the ability to claim any long-term unused AMT credit (i.e., AMT credit that is carried forward over a period of years). Under this provision, an individual's minimum tax credit allowable for any taxable year beginning before January 1, 2013 will not be less than the "AMT refundable amount."

The "AMT refundable amount" is an amount (not in excess of the long-term unused minimum tax credit) equal to the greatest of:

1. \$5,000
2. 20 percent of the long-term unused minimum tax credit, or
3. The AMT refundable credit amount (if any) for the prior taxable year (resulting from the AGI-based phaseout rules)

**Tip:** The Tax Technical Corrections Act of 2007 altered the rules that allow those with long-term unused tax credit carryforwards to be able to take advantage of the credit more easily. This is illustrated by the following example: Assume an individual, whose AGI for all taxable years is less than the threshold amount, has a long-term unused minimum tax credit for 2007 of \$100,000, and has no other minimum tax credits. The individual's AMT refundable credit amount under

pre-Act law would have been \$20,000 in 2007, \$16,000 in 2008, \$10,240 in 2009, \$8,192 in 2010, \$6,554 in 2011, and \$5,243 in 2012. Under the Act, the individual's AMT refundable credit amount is \$20,000 for 2007, and \$20,000 in each taxable years 2008 through 2011.

The long-term unused minimum tax credit means the portion of the minimum tax credit attributable to taxable years before the third taxable year immediately preceding the current taxable year (assuming the credits are used on a first-in, first-out basis).

**Tip:** The additional credit allowable by reason of this provision is refundable.

**Caution:** The AMT refundable credit amount is reduced for individuals with adjusted gross incomes (AGIs) that exceed certain thresholds. The phaseout thresholds that apply for 2008 are \$239,950 for married individuals filing jointly, \$199,950 for individuals filing as head of household, \$159,950 for single individuals, and \$119,975 for married individuals filing separately. Individuals must reduce their AMT refundable credit by 2 percent for every \$2,500 by which their AGI exceeds the threshold amount (\$1,250 for married individuals filing separately).

## Disclosures

This material does not constitute the rendering of investment, legal, tax or insurance advice or services. It is intended for informational use only and is not a substitute for investment, legal, tax, and insurance advice.

State, national and international laws vary, as do individual circumstances; so always consult a qualified investment advisor, attorney, CPA, or insurance agent on all investment, legal, tax, or insurance matters.

The effectiveness of any of the strategies described will depend on your individual situation and on a number of other factors. After reviewing your personal situation, we may recommend that you not use any strategy in this document but instead consider various other strategies available through our practice.

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