

# AMT and the Individual Investor

## INTRODUCTION

The alternative minimum tax (AMT) was first introduced in 1983. Since that time, a number of changes in the AMT, caused by the Revenue Reconciliation Act of 1993 (the “Revenue Act of 1993”) and, before that, the Tax Reform Act of 1986, continue to create questions for many investors. However, once the regulations are reviewed, the majority of investors, especially those who use tax-exempt securities as a major element of their wealth management planning, can breathe a sigh of relief. The number of individuals subject to AMT should continue to be relatively small. In fact, industry sources estimate that less than 2% of all individual taxpayers will be subject to AMT. However, we emphasize that, for a complete explanation of the AMT and how it affects your particular situation, your tax advisor should be consulted.

## WHAT IS THE AMT?

The AMT is a separately computed tax that applies only if it exceeds an individual’s regular tax liability. The purpose of the AMT is to prevent taxpayers who enjoy certain tax benefits from avoiding a reasonable tax liability on their income. For purposes of computing the AMT, certain “preference” items (as well as most itemized deductions) are added back to one’s regular taxable income to arrive at the alternative minimum taxable income (AMTI). An “exemption amount” of up to \$45,000 for joint returns and \$33,750 for single returns is then subtracted. The actual AMT is then calculated by multiplying this remaining balance by the appropriate AMT rate. The Revenue Act of 1993 introduced a new two-tier AMT rate structure for individual taxpayers. For taxpayers whose AMTI less

the exemption does not exceed \$175,000, the AMT is 26% of this amount, and taxpayers must pay whichever tax is higher — the AMT or the tax computed in the regular fashion. For individuals whose AMTI less the exemption is above \$175,000, a 28% rate is applied.

It should be noted that the “exemption amount” is reduced by \$0.25 for every \$1.00 of AMTI in excess of \$150,000 for joint taxpayers and \$112,500 for single taxpayers. Thus, the \$45,000 exemption phases out to zero for joint taxpayers with an AMTI of \$330,000, and the \$33,750 exemption phases out to zero at \$247,500 for single taxpayers.

Although the AMT generally cannot be reduced by tax credits, any such credits can be carried forward to reduce future years’ regular tax liability.

## AMT ADJUSTMENTS

To individual taxable income, certain adjustments are made to compute the AMT. Among these are:

- Standard deductions are not allowed.
- Itemized deductions for taxes and most miscellaneous deductions are not allowed; deductions for other interest and medical expenses are restricted.
- Accelerated depreciation on tangible property placed in service after 1986 is figured under the alternate method of the modified accelerated cost recovery system (MACRS), except that for personal property, a 150% declining balance method is used.
- Circulation expenditures must be amortized ratably over three years.
- Research and experimental expenditures must be amortized ratably over ten years.
- Allowable mining exploration and development costs must be amortized ratably over ten years.



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- Long-term contracts entered into after February 28, 1986, must be figured under the percentage of completion method.
- Amortization on pollution control facilities placed in service after 1986 must be figured under alternate MACRS.
- Certain installment sales by dealers generally do not apply for AMT.
- Alternative tax net operating loss allowed with certain adjustments.
- Excess of fair market value of incentive stock options over option price at date of exercise is generally recognized as income.
- Beneficiaries include their share of distributable AMT taxable income instead of the income reported for regular tax purposes.

### **AMT PREFERENCES**

Preferences that must be added back to taxable income include:

- Certain interest on specified tax-exempt private activity bonds issued after August 7, 1986.
- Excess of depletion deduction or amortization of real property taken over straight-line method.
- Excess of intangible drilling costs for certain properties that are more than 65% of net income for those properties.
- Capital gain exclusion from investment in qualified small business stock.

### **TAX-EXEMPTS AND THE AMT**

One of the above preference items is tax-exempt interest on private activity bonds issued after August 7, 1986. These bonds will be clearly designated by the issuer as “subject to the alternative minimum tax.” Private activity tax-exempts owned

by an individual and issued prior to August 8, 1986, are not subject to AMT. In addition, the AMT does not apply to governmental public purpose bonds and 501(c)(3) bonds issued by certain charitable organizations (such as hospitals or educational institutions) regardless of when issued.

With charitable contributions of appreciated property no longer a preference item for AMT, it may well be possible that tax-exempt interest on private activity bonds will soon become one of the few remaining items of tax preference applicable to most taxpayers.

With regular top tax rate remaining high (36% or 39.6%) compared to the AMT rate (26% or 28%) and tax shelter alternatives so restricted, most taxpayers will be able to receive substantial amounts of interest from private activity bonds issued after August 7, 1986 (plus unlimited amounts of interest from other tax-exempts) without fear of being subject to the AMT.

The table below illustrates how much preference income a married couple filing jointly with two dependent children could earn before they are subject to the alternative minimum tax. It also delineates the par value of certain post-August 7, 1986, private activity bonds the couple could hold before the interest would be subject to the AMT. Both amounts assume that the couple has no other AMT adjustments or preference income.

### **HOW MUCH IS TOO MUCH?**

The question of how much income from private purpose bonds can be earned before facing the alternative minimum tax will depend on each investor. Unless the investor is heavily involved in the more complex tax shelters, there really appears to be little concern because of the exemption allowed.

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Taxable Income	2000 Regular Tax Liability	Approximate Limit of Preference Income	Approximate Par Value of Certain Private Activity Bonds (Amounts in 000s)			
			4.0%	5.0%	6.0%	7.0%
\$75,000	\$15,300	\$10,294	\$257	\$205	\$171	\$147
100,000	22,300	12,217	305	244	203	174
125,000	29,871	14,361	359	287	239	205
150,000	37,621	13,207	330	264	220	188
175,000	46,049	14,029	350	280	233	200
200,000	55,049	16,800	419	335	279	239
250,000	73,049	22,340	558	446	372	319
300,000	91,468	30,912	772	618	515	441
350,000	111,268	52,535	1,313	1,050	875	750
400,000	131,068	73,250	1,831	1,464	1,220	1,046

**CONCLUSION**

For the vast majority of investors not subject to the AMT, we see an investment opportunity in private activity bonds issued after August 7, 1986. Despite the likelihood that the AMT currently does not apply to most individuals, these private activity bonds are being offered at a yield premium to offset the possible application of the AMT. This yield premium, which historically has ranged between 10 and 25 basis points, is a “gift” for most investors.

With Congress voting to permanently extend the ability of small-issue manufacturers to issue tax-exempt industrial development bonds, the supply

of securities that are subject to AMT will certainly increase. For the majority of individual investors, these AMT bonds will represent an excellent investment opportunity.

The subject of AMT bonds is far from simple, and when it comes to complex tax matters, we strongly suggest you contact your tax advisor.

*This material is not intended to replace the advice of a qualified tax advisor, attorney, and accountant or insurance advisor. Consultation with the appropriate professional should be done before any financial commitments regarding the issues related to the situation are made.*

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