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New Relief From Our Old Friend "AMT": Individual Tax Planning

With increasing frequency, taxpayers are becoming subject to the alternative minimum tax ("AMT"). It is an additional tax (i.e., it is imposed to the extent it exceeds the regular income tax liability) that can cast a wide net over many taxpayers. The AMT is a particular problem for taxpayers who exercised incentive stock options ("ISO") since the exercise of an ISO would be taxable for AMT purposes and could create a substantial AMT liability even though the exercise was generally not taxable for regular tax purposes.

The Tax Relief and Health Care Act of 2006 brings significant AMT relief in the form of a "refundable credit" resulting from the payment of the AMT. A brief review of how the AMT works is helpful in order to better understand the mechanics of the new tax relief.

How AMT Works

The AMT is the amount by which the "tentative minimum tax" exceeds your regular income tax liability (i.e., your tax liability as you would compute it using the IRS rate schedule). The "tentative minimum tax" is the sum of 26% of the "taxable excess" up to $175,000, and 28% of the remaining "taxable excess." The "taxable excess" is the amount by which alternative minimum taxable income ("AMTI") exceeds an exemption amount. AMTI is the regular taxable income increased by items of preference and adjusted for certain items known as timing items which have income deferral components (e.g., gain from exercise of incentive stock options and accelerated depreciation.) AMT (for individuals) which is attributable to such deferral adjustments generates a minimum tax credit allowable to the extent regular tax exceeds the AMT tax in a future year. If these credits are not used, they are carried forward indefinitely. Credits such as these can reduce your future income tax liability dollar for dollar.

AMT and ISOs

In the case of ISOs, the theory behind the AMT is that it results in only a tax payment timing issue since when the stock is eventually sold, the AMT credit would be available to offset the regular tax due on the sale of the stock. By way of example of how AMT strikes, consider an individual taxpayer who exercises a grant of ISOs. Although this exercise will generally not cause a regular income tax liability, the excess of the fair market value of the underlying stock at the date of exercise over the amount paid for the stock is treated as income for AMT purposes and often results in a substantial AMT liability. While such liability results in a credit that is carried forward, taxpayers often find that the value of the stock obtained from an ISO exercise decreases substantially from the date of ISO exercise to the date of sale, so that on the sale of the stock there is little or no regular income tax gain on the sale. This means that AMT is paid on "phantom gain" and the AMT credit may carry over for years without being used to any substantial extent.

The New Rules

Congress responded to this tax anomaly by creating a refundable AMT credit. Beginning in 2007 and effective through 2012, an individual who previously paid AMT that gave rise to a credit can recover a portion of the "long term unused minimum tax credit" (tax credit from years that are more than three years earlier than the applicable tax year).

For example, for the 2007 tax year, individuals can recover AMT paid for any year up to and including 2003. The annual limit of recovery is generally 20% of the carry-forward AMT credit each year subject to the reduction of the refundable credit (by applicable percentages) based upon the taxpayer's adjusted gross income. However, if the applicable AMT credit is $5,000 or less, the taxpayer may be permitted to use the entire credit amount in a single year.

By way of illustration, if an individual has $50,000 of AMT credit (from an ISO exercise in 2003), he can now use $10,000 (20% of the $50,000 AMT credit) of the credit in the 2007 tax year and then use the remaining $40,000 AMT credit for the 2008-2011 tax years at the rate of $10,000 per year.

A key aspect of the new legislation is that the credit is refundable to the extent it exceeds the taxpayer's regular tax liability. This means you can claim a refund to the extent that the AMT credit exceeds the amount of tax you previously paid through withholding or estimated tax. Under the prior AMT credit rules, you would have been able to use the AMT credit only to the extent of your regular tax for that year and would be able to carry forward any unused amounts. The new legislation results in an "acceleration" of the AMT credit that did not exist under prior law.

Planning Opportunities

Although the refundable AMT credit is not limited to ISO exercises, clients who have exercised ISOs in prior recent years should examine their current situation to determine if they can take advantage of this new provision. The mechanics of calculating the credit amount can be determined by completing IRS Form 8801. Of course, the AMT effects should be examined in light of an individual's income levels and the other limitations of the new law.

If you have any questions about this topic, or any other tax law concerns, contact Charles A. Bruder or Melinda Fellner Bramwit to discuss.

This *Alert* was authored by **Charles A. Bruder** and **Melinda Fellner Bramwit.**

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