Alternative Minimum Tax

This tax by far is the most complex confusing and downright dumb tax there is in my option. REMEMBER BACK when disc was king and you heard about all those rich people who paid nothing in income taxes? Well, you weren't alone, and that anger led to the creation of something called the alternative minimum tax, which was designed to keep the rich from living tax-free.

Fast-forward a few years. You're a bit older, somewhat better off and paying far more in taxes than you ever thought possible. So what's the last thing you expect to see when you fill out your tax return? That you owe the alternative minimum tax. You can take some solace in the fact that thousands of taxpayers just like you have been snagged by this nasty bit of tax law in recent years. While only 19,000 people owed the AMT in 1970, millions are paying it now.

What happened? Inflation, mostly. While the "regular" tax brackets, exemptions and standard deductions are adjusted annually for inflation, the AMT brackets and exemptions are not, so many people whose income has grown with the economy enter the dreaded AMT zone each year. Especially vulnerable are people with income over $75,000 and some large deductions, but not the exotic ones that were originally targeted by the AMT's creators. Most vulnerable are taxpayers with several children, interest deductions from second mortgages, capital gains, high state and local taxes, and incentive stock options.

How the Tax Works
The best way to understand the AMT is to view it as a separate tax system. It has its own set of rates and its own rules for deductions, which usually are less generous than the regular rules. Because of these confusing rules, the only ways you can tell if you owe the tax are by filling out the forms (essentially doing your taxes a second time) or by being audited by the Internal Revenue Service. If it turns out you should have paid the AMT but didn't, you will owe the back taxes plus any interest or penalty that the IRS decides to dole out.

You should definitely run the numbers if your gross income is above $75,000 and you have write-offs for personal exemptions, taxes and home-equity loan interest. Ditto if you exercised incentive stock options during the year, or if you own a business, rental properties, partnership interests or S corporation stock. If you earn more than $100,000, run the numbers for that reason alone.

That means filling out Form 6251. In effect, you are simply adding back some tax deductions and income exclusions to your regular taxable income to arrive at your alternative minimum taxable income. Here is where the middle class gets soaked. First you have to add back your personal- and dependent-exemption deductions ($3,650 each in 2010 & $3,700 in 2011), then your standard deduction if you don't itemize ($11,600 for joint filers in 2011 and $10,400 for joint filers in 2010; $5,700 for singles in 2010 and $5,800 for singles in 2011). You also lose your state, local and foreign income and property-tax write-offs, as well as your home-equity loan interest, if the loan proceeds are not used for home improvements.

The AMT also ignores some itemized deductions, such as investment expenses and employee business expenses, and some medical and dental expenses. It also counts as income the interest from private-activity bonds, a type of tax-exempt bond issued by governments, usually to finance sports stadiums and the like. Finally, AMT rules force you to pay taxes on the "spread" between the market price and the exercise price of incentive stock options granted by your employer. For example, if you exercised an option to buy 100 shares of stock for $3 a share and the stock was trading at $10, the spread would be $7 a share, or $700. Under the regular rules, you wouldn't pay current taxes on that amount, but under the AMT, it's considered income.

Don't give up hope. You do get a few small breaks under AMT rules that you wouldn't see under the regular tax rules. For example, while you can't deduct state, local and foreign taxes under AMT rules, you can deduct the refunds, which would be considered income under the regular tax rules. And because you're taxed on the spread on your incentive stock options, your tax basis for the shares you bought is higher under the AMT, meaning your tax bill will be lower when you sell the shares.

The AMT form has quite a few other pluses and minuses, but you can probably ignore them unless you own a business, rental properties or interests in partnerships or S corporations. If you do, you may need a tax pro to prepare at least the Form 6251 part of your return.

Finally, you get to deduct the AMT exemption — $74,450 for 2011 joint filers; $48,450 for unmarried persons; $37,225 for those married filing separately. However, this exemption is reduced by 25 cents for each dollar of AMT taxable income above $150,000 for couples ($112,500 for singles and $75,000 for married filing separate status), and it's not adjusted for inflation, which is one reason why more people owe the AMT every year.

After the exemption (if any) has been deducted, the result is subject to AMT rates — 26% on the first $175,000 ($87,500 for married couples filing separately) and 28% on the excess. Again, the AMT brackets are not adjusted for inflation, which causes much greater exposure to the tax as the years go by. If the AMT exceeds your regular tax, you have to pay the greater amount. Technically, the AMT is just the liability over and above the regular tax, and this figure is entered on page 2 of Form 1040.

Sorry, you're not finished yet. People get pushed into the AMT zone for different reasons, and some are actually better than others. That's because you could be eligible for the so-called minimum tax credit, which allows you to claim a credit on your tax return in future years for some of the extra taxes you paid under AMT rules. So you have to fill out another document, Form 8801, to determine if you are eligible. For whatever reason, the tax rules say that exercising incentive stock options is one of the few things that qualify you for the credit, so if that's the reason you ended up paying the AMT, pay special attention to this form.