

# TAX PLANNING LETTER

MARCH 2018, #296

## TCJA Provides AMT Relief

Although it was hoped that tax reform discussions would yield the complete repeal of the individual Alternative Minimum Tax (AMT), it nevertheless is still in force under the Tax Cuts and Jobs Act (TCJA). That said, the rules under AMT have become more taxpayer-friendly. In addition, other changes within TCJA have the effect of mitigating the possibility that AMT will impact taxpayers for the period 2018-2025. So beginning with 2018, many taxpayers to which AMT applied will find that this is no longer the case whereas others will find that the amount of AMT owed will have decreased.

This Tax Planning Letter provides an overview of the changes to the AMT in 2018-2015 as compared with the pre-TCJA law still effective for 2017 returns.

### AMT PRINCIPLES

#### AMT is a separate tax system

Although it bears a strong resemblance to the regular tax system, the primary differences are:

- Certain income that is tax-free under the regular tax system is taxed under AMT
- Certain tax deductions available under the regular tax system are not deductible under AMT
- The maximum AMT rate is a reduced 28% versus the 39.6% maximum tax rate under the regular tax system (37% under TCJA)

#### Income Levels at which AMT is Activated

- (2017) the maximum 28% AMT rate activates when AMT income >\$187,800 for married joint-filing couples and \$93,900 for others
- (2018) the 28% AMT rate activates when AMT income >\$191,500 for married joint-filing couples and \$95,750 for others

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#### AMT Exemption

A relatively large inflation-adjusted AMT exemption is provided, that affords a deduction in arriving at AMT income. These exemptions are significantly increased by TCJA for the years 2018-2025. While the exemption is phased out when your AMT income surpasses an applicable threshold, these thresholds are notably increased by TCJA.

#### AMT is the Amount by Which AMT Tax Exceeds Regular Tax

If the AMT tax exceeds regular tax, AMT is due. While the AMT liability is technically the amount by which the AMT exceeds the regular tax, this discussion will refer to the entire amount calculated under the AMT rules as the AMT liability.

#### FACTORS CAUSING AMT (PRE-TCJA)

Due to ongoing changes in the tax code, the pre-TCJA AMT had become a non-issue for many high-income taxpayers. Reason being that more and more tax breaks were becoming less effective, and thereby reduced, prior to arriving at the AMT calculation as follows:

- One example is the Passive Activity Loss (PAL) rules which reduced the deductions that can be taken on investments such as rental property and limited partnership interests. As such, many of the regular tax deductions, which would have been added back under the alternative minimum taxable income (AMTI) calculation, were not allowed under the regular tax system anyway.
- Another example is that, once a taxpayer's income exceeds certain thresholds, phase-out rules kick in which curtail and/or otherwise eliminate entirely other tax breaks. The result is that many high-income taxpayers had few or no tax breaks left to lose prior to arriving at the AMT calculation. Of the high-income taxpayers that still did, the pre-TCJA top rate of 39.6% was so high that the 28% AMT rate would never come into play.
- Finally, the AMT exemption (which is an amount that is deducted in arriving at AMT income) is phased out as income goes up. Under pre-TCJA AMT, the result is that, although the exemption had little or no impact on individuals with very high incomes because the exemption had long since been phased out, the exemption phase-out rule did cause upper-middle-income taxpayers to be more likely to owe AMT.

The result of all these factors was that:

- Many upper-middle-income taxpayers paid AMT, while
- Many taxpayers with very high incomes just owed the regular tax

## FACTORS CAUSING AMT (TCJA)

Because a tax return is so multi-faceted and tax concepts are interrelated, it is difficult to ascertain in a vacuum what taxpayer will pay AMT, and what taxpayer will not. With that in mind, the following are the most common factors under TCJA that apply for 2018-2025.

### High Income

High income (from whatever source) can cause the AMT exemption to be partially or completely phased out, which generally increases the likelihood of owing the AMT. The following tables present the AMT exemption and phase-out amounts for various filers under pre-TCJA vs TCJA. Under both pre-TCJA and TCJA, the exemption amount is reduced by 25% of the excess of AMT income over the applicable phase-out threshold. As can be seen, under TCJA, only those with very high incomes will see their exemptions phased out while upper-middle-income taxpayers will benefit from full exemptions.

2017 under Pre-TCJA	Married Filing Joint (MFJ)	Single	Married Filing Separate (MFS)
AMT Exemption Amount	\$ 84,500	\$ 54,300	\$ 42,250
AMT Phase-out Begins	\$ 160,900	\$ 120,700	\$ 80,450
AMT Phase-out Concludes	\$ 498,900	\$ 337,900	\$ 249,450

2018 under TCJA	Married Filing Joint (MFJ)	Single	Married Filing Separate (MFS)
AMT Exemption Amount	\$ 109,400	\$ 70,300	\$ 54,700
AMT Phase-out Begins	\$ 1,000,000	\$ 500,000	\$ 500,000
AMT Phase-out Concludes	\$ 1,437,600	\$ 781,200	\$ 718,800

TCJA creates two changes that offset each other:

- Whereas TCJA lowered 5 out of 7 regular tax rates, the AMT rates remain the same at 26% and 28%. This increases the possibility that AMT will come into play.
- Alternatively, the aforementioned liberalization of the AMT exemption rules under TCJA has the opposite effect.

The interaction of these two disparate factors may result in many upper-middle-income taxpayers still owing the AMT, but in lower amounts than under pre-TCJA.

## Itemized Deductions for State and Local Taxes

State and local taxes are deductions which are disallowed under the AMT calculation. This means that while these taxes are fully deductible under pre-TCJA for regular income tax, they are disallowed in their entirety in calculating AMTI. Since TCJA has limited the deduction for state and local income taxes (inclusive of property tax) to \$10,000 for 2018 – 2025, this formerly significant adjustment has become largely a non-issue.

## Personal and Dependent Exemptions

The AMTI calculation does not allow any deductions for personal and dependent exemptions. Now that TCJA has also eliminated these deductions for 2018 – 2025, personal and dependent exemptions have also become a non-issue.

## Exercise of Incentive Stock Options (ISOs)

While the amount by which the market value of shares on the exercise date exceed the exercise price is not taxable income for regular tax, such income is taxable for AMT. This variance remains the same under TCJA.

## Miscellaneous Itemized Deductions

Included in this category are expenditures for such things as:

- Unreimbursed employee expenses
- Certain legal and accounting fees
- Investment expenses
- Certain losses on non-federally insured deposits in an insolvent or bankrupt financial institution.
- Certain casualty and theft losses

These expenses can be written off for regular tax purposes, but are completely disallowed under the AMT rules. Since TCJA eliminates miscellaneous itemized deductions in their entirety for regular tax purposes, miscellaneous itemized deductions have also become an AMT non-issue.

## Interest Income from Private Activity Bonds

This interest is tax-free for regular tax purposes, but taxable under the AMT rules. The Private Activity Bond interest adjustment remains under TCJA.

## Depreciation Deductions

Regular tax depreciation deductions from a business and/or investment in S corporations, LLCs, and partnerships can create AMT adjustments that increase AMT income and the likelihood that the AMT will be owed. This is because AMT depreciation methods and lives are generally less favorable than those which are used for regular tax purposes.

Under TCJA, businesses can immediately deduct the entire cost of many depreciable assets placed in service between 9/28/17 and 12/31/22 under both the regular tax rules and the AMT rules. As such, although the AMT adjustment associated with depreciation is diminished for newly added assets, it remains for older assets that are still being depreciated under pre-TCJA rules.

## Home Equity Loan Interest

### PRE-TCJA

- For regular tax purposes, interest on up to \$100,000 of home equity loan balances can be deducted.
- Under the AMT rules, the interest can be deducted only to the extent the loan proceeds were used to acquire or improve a qualified residence.

TCJA

For 2018-2025, the TCJA generally disallows deductions for home equity loan interest. In certain cases, it may be possible to treat a home equity loan as acquisition indebtedness if the proceeds were used to acquire or improve a qualified residence and the total acquisition indebtedness does not exceed \$750,000. In these cases, the home equity loan interest would be deductible under both the regular tax and AMT rules. However, the interest on most home equity loans will be disallowed for regular tax purposes under the TCJA.

**Standard Deductions**

- Standard deductions are allowed under the regular tax rules
- Standard deductions are completely disallowed under the AMT rules.

Under TCJA, for 2018-2025, the standard deduction amounts are nearly doubled. Considering the \$10,000 state and local tax limitation, many taxpayers that have always itemized their deductions, may no longer need to do so. As such, the likelihood of seeing a standard deduction add back in an AMTI calculation is greatly increased.

**THE MINIMUM TAX CREDIT****(FORM 8801 - CREDIT FOR PRIOR YEAR MINIMUM TAX-INDIVIDUALS, ESTATES, AND TRUSTS)****Background**

A portion of the AMT paid by an individual taxpayer can potentially generate the so-called Minimum Tax Credit (MTC). The MTC then can be used to reduce the taxpayer's regular tax liability in future years, but only to the extent by which the regular tax liability for the applicable year exceeds the AMT liability for that year. That is to say that the MTC cannot reduce the regular tax liability below the AMT liability. Any unused MTC can be carried forward for an unlimited number of years.

**Deferral Preferences vs Exclusion Preferences**

- **Deferral Preferences** are essentially "timing differences", that is items that are recognized at different times for regular tax purposes and AMT purposes such as depreciation deductions.
- **Exclusion Preferences** are essentially "permanent differences", that is items that are permanently treated differently under the regular tax and AMT rules. Examples of exclusion preferences are:
  - Itemized deductions that are disallowed under the AMT rules (such as state and local taxes and miscellaneous itemized deductions allowed before TCJA),
  - Home equity loan interest expense, if the loan proceeds were not spent on a qualified residence,
  - Standard deductions, and
  - Personal and dependent exemptions allowed before TCJA.

Most other AMT adjustments and preferences are deferral preferences that will potentially generate MTCs. For example, the aforementioned ISO exercise adjustment and AMT depreciation adjustments are deferral preferences. To the extent TCJA reduces or eliminates certain exclusion preferences, taxpayers who owe the AMT after TCJA will most likely generate more MTCs than under Pre-TCJA.

The MTC is calculated on Form 8801 and is filed for the tax year after the year the taxpayer pays the AMT, to calculate the MTC that was generated in the preceding year.

**Questions?**

For more details on information presented in this Tax Planning Letter or other issues, please feel free to call Roger Rossmeisl, CPA direct at (714) 325-0442 or via e-mail at [roger@khopatel.com](mailto:roger@khopatel.com).

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