

1986

The Alternative Minimum Tax for Individuals: Outline

Richard E. Fogg

Repository Citation

Fogg, Richard E., "The Alternative Minimum Tax for Individuals: Outline" (1986). *William & Mary Annual Tax Conference*. 570.
<https://scholarship.law.wm.edu/tax/570>

THE ALTERNATIVE MINIMUM TAX FOR INDIVIDUALS

OUTLINE

By

Richard E. Fogg*
Price Waterhouse
Richmond, Virginia

I. In Search of a "Fair" Minimum Tax

- A. Tax Reform Act of 1969. Tax Reform Act of 1969 introduced the concept of a minimum tax. A minimum tax was imposed on 10% of the taxpayer's tax preference items reduced by a \$30,000 exemption. The tax applied to the extent that it exceeded the taxpayer's federal income tax reduced by credits. In 1976, Congress significantly tightened the minimum tax rules. The minimum tax rate increased to 15% and the exemption was reduced to the greater of \$10,000 or one-half of the regular tax liability. The list of tax preferences was expanded and the carryover of excess regular taxes was repealed.
- B. Revenue Act of 1978. The Alternative Minimum Tax for taxpayers other than corporations was introduced in the Revenue Act of 1978, Sec. 421(a), and applies to tax years beginning after December 31, 1978. The Senate Finance Committee noted that the "Add-On Minimum Tax" does not well serve either the goal of tax equity or the goal of encouraging capital formation and economic growth by means of tax incentives. Because the tax does not fully depend on the amount of regular taxes paid by the taxpayer, the present minimum tax can result in a substantial tax increase for individuals already paying regular taxes and high rates. S.REP. No. 95-1265, 95th Cong., 2nd Sess. 201 (1978), 1978-3 C.B. 315, 499.
- C. Economic Recovery Act of 1981 (ERTA). In 1981, the Alternative Minimum Tax was revised by the Economic Recovery Tax Act of 1981. These changes were generally limited to conforming the Alternative Minimum Tax to technical and tax rate provisions of the act.

* The author wishes to express appreciation to Robert L. Mandel, Tax Senior, Price Waterhouse, Richmond, for his assistance in developing this outline.

- D. Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA). In 1982, the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA), eliminated the Add-On Minimum Tax and significantly altered the Alternative Minimum Tax.
- a. Congressional intent. Congress amended the present minimum tax provisions applying to the individuals with one overriding objective - that no taxpayer with substantial economic income should be able to avoid all tax liability by using exclusions, deductions and credits. They explained that the ability of high income individuals to pay little or no tax undermines respect for the entire tax system and, thus, for the incentive provisions themselves. Therefore, Congress provided an Alternative Minimum Tax which was intended to ensure that, when an individual's ability to pay taxes is measured by a broad based concept of income, a measure which can be reduced by only a few of the incentive provisions, tax liability is at least a minimum percentage of that broad measure (See, generally, the General Explanation of the Revenue Provisions of the Tax Equity and Fiscal Responsibility Act of 1982 prepared by the staff of the Joint Committee on Taxation, beginning at page 16).
- b. Summary of TEFRA changes. For years beginning in 1983 several new tax preferences were added, the treatment of itemized deductions was restructured, a flat 20% rate was established, and the minimum tax exemption was increased to \$30,000 for unmarried persons and \$40,000 for married couples.
- E. Tax Reform Act of 1984. Additional technical and clarifying amendments to Sec. 55 and 57 were made in the Tax Reform Act of 1984.
- F. Tax Reform Act of 1986. This act recognizes that the provisions of TEFRA are not broad enough to ensure that individuals with substantial economic income are not able to avoid significant tax liability by using exclusions, deductions, and credits. Although these incentives are provided to promote social objectives and other goals, Congress feels that the perceived unfairness in the tax systems due to these incentives continue to outweigh their inherent values.

The new alternative minimum tax provisions include more preferences, a broader interpretation of existing preferences, and the concept of adjustments for deferral preferences. These adjustments, unlike exclusion preferences, may benefit the taxpayer. They recognize the fact that certain items defer taxable income rather than exclude it and they allow the taxpayer to carry deferral credits against regular tax liability in future years through minimum tax credits. (See, generally, the Reasons for Change of the Report of the Committee on Finance United States Senate to accompany H.R. 3838, beginning at page 518.)

II. Current Law

A. There are Three Sections in the Internal Revenue Code that Pertain to the AMT for Individuals.

1. Sec. 55 - imposes an alternative minimum tax on taxpayers other than corporatons;
2. Sec. 57 - defines the items of tax preference;
3. Sec. 58 - provides rules for the application of the AMT.

B. Review of Sec. 55

1. Tax Imposed.

For individual taxpayers, a tax of 20% is imposed on the excess, if any, of the Alternative Minimum Taxable Income (AMTI) over the exemption amount. This tax is payable to the extent it exceeds the regular tax for the taxable year. Sec. 55(a)(1) and (2).

2. AMTI is Defined in Sec. 55(b).

- a. Adjusted gross income ("AGI"), without regard to the net operating loss ("NOL") deduction allowed by Sec. 172;
- b. Reduced under Sec. 55(b)(1) by:
 - (1) The alternative tax NOL deduction;

(2) The alternative tax itemize deductions; and,

(3) Alcohol fuel credits included in gross income (Sec. 87) and throwback trust distributions (Sec. 667).

c. Increased under Sec. 55(b)(2) by the items of tax preference.

3. The Alternative Tax NOL is Defined in Sec. 55(d).

In general, it is the same NOL as determined under Sec. 172, except tax preference deductions are not allowed, and only the alternative tax itemized deductions are allowed. This will have the effect of making AGI a larger amount where such items exist.

4. The Alternative Minimum Tax Itemized Deductions.

They are defined in Sec. 55(e) to include:

(1) Casualty losses under Sec. 165(c)(3) and wagering losses under Sec. 165(d);

(2) Charitable contributions;

(3) Medical deductions;

(4) "Qualified interest" as defined in Sec. 55(e)(3); and,

(5) The deduction for estate taxes.

5. Exemption Amounts.

The exemption amounts provided in Sec. 55(f) are:

(1) \$40,000 for a joint return or surviving spouse;

(2) \$30,000 for a single taxpayer; or

(3) \$20,000 for married filing separate or an estate or trust.

6. Summary of AMT.

The alternative minimum tax can be calculated as follows:

Adjusted gross income (before NOL)
less

The NOL deduction (if any)
less

The alternative tax itemized deductions
less

The alcohol fuel credits and throwback distributions (if any)
plus

All tax preference items
equals

Alternative minimum taxable income (AMTI)
less

The exemption amount
equals

AMT base

AMT base multiplied by 20%, less the regular tax, is the alternative minimum tax.

7. The Regular Tax for Purposes of Sec. 55.

It is defined by Sec. 55(f)(2) as the taxpayer's regular tax, excluding the taxes for disposed general business property, annuities, pension plan lump-sum distributions, early dispositions from IRA's, and trust accumulation distributions.

- a. The regular tax, as described above, is then reduced by all tax credits except the refundable credits of withheld income tax (Sec. 31), the earned income credit (Sec. 32), tax withheld at source on nonresident aliens and foreign corporations (Sec. 33), credits for use of gasoline and fuels for farming and nontaxable purposes (Sec. 34), and overpayments of tax (Sec. 35).

8. Payment of Difference Required.

If the taxpayer's gross AMT exceeds his regular tax, he must pay this difference! Thus, other credits are not available to offset this liability. Therefore, Sec. 55(c)(3) is intended to provide these credits can be carried over to the extent they are not used to offset the AMT liability. These credits are the residential energy credit (Sec. 23), the credit for interest on certain home mortgages (Sec. 25), the research credit (Sec. 30), the alcohol fuels credit (Sec. 40), the ESOP credit (Sec. 41), the investment tax credit (Sec. 46) and the targeted jobs credit (Sec. 51).

9. The Foreign Tax Credit May Reduce AMT Liability.

Therefore, Sec. 55(c)(2) provides rules that allow it only to offset such tax to the extent of the foreign tax on foreign source AMTI.

C. A Review of Sec. 57

1. Sec. 57 Defines the Items of Tax Preference.

There are twelve which are set forth below.

- a. The dividends received exclusion.
- b. For each item of depreciable real property (Sec. 1250 property), the excess of accelerated depreciation over "as-if" straight line depreciation.
- c. For each item of personal property (Sec. 1245 property) subject to a lease, the excess of accelerated depreciation over "as-if" straight line depreciation.
- d. For each certified pollution control facility, the excess of the 60-month amortization over the "as-if" straight line depreciation.

- e. For each mine or other hard mineral deposit, the excess of the development expenses and mining exploration expenditures allowed under Sec. 616 and 617 over a straight line amortization expense over a 10-year life.
- f. For circulation, the excess of circulation expenses over a 3-year straight line amortization of such expenses.
- g. For research and experimental expenditures, the excess of research and experimental expenses over a 10-year straight line amortization of such expenses.
- h. For depletion, the excess of statutory depletion over the adjusted basis of the property at the end of the taxable year (determined without regard to current year depletion).
- i. For capital gains, the 60% net capital gain deduction.
- j. For incentive stock options (ISO's), the excess of the fair market value of the stock over the exercise price at the time of exercise.
- k. In general, the amount by which the excess productive well intangible drilling costs (IDC) exceed the taxpayer's net income from oil and gas properties is a tax preference item. The excess IDC is the excess of such IDC over a straight line amortization of such IDC over 10 years or amortization on a units-of-production basis.
- l. With respect to ACRS property subject to a lease, the excess of ACRS depreciation over defined straight line depreciation.

D. Election to Amortize Provision of Sec. 58

1. General.

Sec. 58(i)(1) generally provides the individual taxpayer an election to ratably amortize over 10 years (3 years for circulation expenditures) expenditures which are otherwise currently deductible. The election can be made with respect to any qualified expenditure and is made to avoid the inclusion of these expenditures as tax preference items.

2. Qualified Expenditures as Provided by Sec. 58(i)(2).

- (1) Circulation expenditures under Sec. 173;
- (2) Research and experimental expenditures under Sec. 174;
- (3) IDC under Sec. 263(c);
- (4) Mining development expenses under Sec. 616(a); or
- (5) Mining exploration expenses under Sec. 617.

3. Special Election for IDC.

Allowed under Sec. 58(i)(4) to treat "non-limited IDC" as a 5-year ACRS property eligible for ITC.

- (1) Non-limited IDC is IDC not allocable to a "limited business interest" as defined in Sec. 55(e)(8)(C).
- (2) Election is made at partner (or S corporation stockholder) level. Therefore, IDC must be separately stated on Schedule K-1.

E. A Closer Look at the Itemized Deduction for Qualified Interest

1. Definition.

Sec. 55(e)(3) defines qualified interest as the sum of:

- a. Qualified housing interest; and,

- b. Other interest to the extent it does not exceed the qualified net investment income of the taxpayer.

2. Qualified Housing Interest.

Under Sec. 55(e)(4), qualified housing interest includes interest on indebtedness for:

- (1) The taxpayer's principal residence; and,
- (2) A "second home" (a vacation home) of the taxpayer.

3. Qualified Net Investment Income.

Under Sec. 55(e)(5), qualified net investment income is the excess of qualified investment income under Sec. 55(e)(5)(B) over qualified investment expenses under Sec. 55(e)(5)(C).

- (1) Investment income is defined under Sec. 163(d)(3)(B), which is interest, dividends, rents and royalties, net short term capital gains, and depreciation recapture;
- (2) Capital gain net income; and
- (3) The dividend exclusion.

4. Qualified Investment Expenses.

Under Sec. 55(e)(5)(C), qualified investment expenses means deductions directly connected with the production of qualified investment income to the extent:

- (1) Such deductions are allowable in computing AGI; and
- (2) Such deductions are not tax preference items.

5. Income or Loss from Limited Business Interests.

These are taken into account in computing qualified net investment income.

- (1) Limited business interest means an interest as a limited partner in a partnership or a shareholder in an S corporation if the taxpayer does not actively participate in management.

III. New Law: Tax Reform Act of 1986

A. There are six Sections in the Internal Revenue Code that Pertain to the AMT for Individuals:

1. Sec. 55 - imposes an alternative minimum tax.
2. Sec. 56 - provides adjustments in computing alternative minimum taxable income.
3. Sec. 57 - defines the items of tax preference.
4. Sec. 58 - provides additional adjustments for certain losses in computing alternative minimum taxable income.
5. Sec. 59 - defines other items applicable to the alternative minimum tax and provides several special rules.
6. Sec. 53 - introduces a credit for minimum tax liability in prior years.

B. Review of Sec. 55

1. Tax imposed

For individual taxpayers, there is an additional tax of the excess, if any, of the tentative minimum tax (TMT) over the regular tax. Sec. 55(a).

2. TMT is defined in Sec. 55(b)(1)

The TMT is 21 percent of the excess of the alternative minimum taxable income tax (AMTI) over the exemption amount, reduced by the AMT foreign tax credit (FTC).

3. AMTI is defined in 55(b)(2)

It includes the adjustments in Sec. 56 and 58 and the tax preference items in Sec. 57.

4. Exemption Amounts

The exemption amounts provided in Sec. 55(d) are:

- a. \$40,000 for a joint return or a surviving spouse;
- b. \$30,000 for a single taxpayer; or
- c. \$20,000 for a married taxpayer filing a separate return or an estate or trust.

These exemption amounts are reduced by 25 percent of the amount by which the AMTI of the taxpayer exceeds (1) \$150,000, (2) \$112,500, (3) \$75,000, respectively.

5. Summary of Minimum Tax

Taxable Income
plus/minus

All Adjustments
plus

All Tax Preference Items
equals

AMTI
less

The Exemption amount
this quantity multiplied by

21 Percent Rate
less

AMT Foreign Tax Credit
equals

TMT
Compare TMT with the Regular Tax. If TMT is higher, it must be paid. If Regular Tax is higher, it may be reduced by the Minimum Tax Credit (MTC) to the amount of the TMT; then, it must be paid!

6. The Regular Tax for Purposes of Sec. 55

Regular tax liability (Sec. 26(b)), reduced by the allowable foreign tax credit (Sec. 27(a)).

- a. It does not include any tax imposed on lump sum distributions to a beneficiary of a trust under 402(e).
- b. It does not include any increase in tax on certain dispositions of Sec. 38 properly under Sec. 47.

C. Review of Sec. 56

1. Sec. 56 Defines the Adjustments in Computing AMTI.

There are nine which are set forth below:

- a. Depreciation - Regular taxable income must be increased or decreased by the "net" difference between ACRS depreciation and alternative method depreciation. This provision applies to property placed in service after 1986.
- b. Mining exploration and costs - The excess of expensing over 10-year amortization is an adjustment.
- c. Certain long-term contracts - Methods of accounting for long-term contracts that permit deferral of income during the contract period (e.g., completed contract method), are treated as an adjustment by requiring use of the percentage of completion method for minimum tax purposes in post-March 1, 1986 long-term contracts.
- d. NOLs - The regular tax NOL is replaced by an AMT NOL, which is a separate calculation of the current year AMT NOL plus the AMT NOL carry-over, if any. AMT NOLs are allowed to offset up to 90 percent of AMTI. Amounts disallowed by reason of this limitation may be carried over to other taxable years.

- e. Pollution control facilities - The excess of 60-month amortization on certified pollution control facilities over alternative depreciation is an adjustment.
- f. Installment method of accounting - Use of the installment method of accounting is treated as an adjustment by not permitting use of the installment method for minimum tax purposes on sales after March 1, 1986. This applies to all transactions subject to proportionate disallowance of the installment method (i.e., dealer sales and sales of a trade or business or rental property where the purchase price exceeds \$150,000).
- g. Itemized deductions - Most regular tax itemized deductions are allowed for AMT purposes. The following itemized deductions are not allowed:
 - i. state and local taxes
 - ii. real estate taxes
 - iii. medical expenses not greater than 10 percent of AGI
 - iv. miscellaneous deductions greater than 2 percent of AGI (e.g., tax preparation fees and professional dues)
 - v. interest expense other than home mortgage interest and investment interest to the extent of net investment income.
 - o Upon a refinancing of a loan that gives rise to qualified housing interest, interest paid on the new loan is treated as qualified housing interest to the extent that it qualified under the prior loan and the amount of the loan was not increased. The definition of net investment income

is conformed to the definition for regular tax purposes, although determined with regard to minimum tax items of income and deduction. There is also a carryover of investment interest deduction that is disallowed.

- o the phase-in rule for investment interest for regular tax purposes is disregarded for AMT purposes.

vi. standard deduction

- h. Circulation - The excess of expensing over 3-year amortization.
- i. Research - Experimental expenditures - the excess of expensing over 10-year amortization.

D. Review of Sec. 57

1. Sec. 57 Defines the Items of Tax Preference.

There are six which are set forth below:

a. Percentage Depletion

The excess of percentage depletion over the adjusted basis of the depletable property.

b. Intangible Drilling Costs

The excess of expensing over 10 year amortization or cost depletion to the extent in excess of 65 percent of oil and gas income.

c. Incentive Stock Options (ISOs)

The excess of the FMV over the exercise price of the stock. The stock acquires a basis of its exercise price for regular tax purposes, but its FMV for minimum tax purposes.

d. Tax-exempt interest

Interest on private activity bonds issued on or after August 8, 1986. Certain refundings of pre-1986 bonds, however, are not treated as a preference.

e. Appreciated property charitable deduction

The amount of untaxed appreciation allowed as a regular tax deduction is a preference. This preference does not apply to carryovers of the deduction from charitable contributions made prior to August 16, 1986.

f. Accelerated depreciation

For property placed in service before 1987, the excess of accelerated over straight-line depreciation on real property and leased personal property is a preference.

E. Review of Sec. 58

1. Sec. 58 Denies Passive Losses.

There is a four-year phase-in period beginning in 1987 during which a limited amount of passive losses may be used to offset earned income and portfolio income for regular tax purposes, but not for minimum tax purposes.

a. Passive farm losses

Net losses from farming activities in which the taxpayer does not materially participate are treated as a minimum tax preference.

b. Passive trade or business activity losses

Net losses from trade or business activities in which the taxpayer does not materially participate are treated as a minimum tax preference. These passive losses follow the regular tax rules.

i. The regular tax rules permit up to \$25,000 of losses and credit from rental real estate activities in which the taxpayer actively participates to offset non-passive income of the taxpayer, with a phase-out ratably between \$100,000 and \$150,000 of AGI. These losses and credits should not be preference items.

c. Passive losses may be carried forward and treated as a deduction against AMTI passive gains in succeeding years.

F. Review of Sec. 59

1. Sec. 59 Provides Definitions and Special Rules.

a. AMT Foreign Tax Credit

AMT foreign tax credits are allowed to offset a maximum of 90 percent of TMT liability. Any excess may be carried back or forward into other years.

b. Election to Amortize Provision

This provision generally allows the individual taxpayer an election to ratably amortize over 10 years expenditures which are otherwise currently deductible, to avoid the inclusion of these expenditures as tax preference items.

G. Review of Sec. 53

1. Sec. 53 Provides a Minimum Tax Credit (MTC) for Deferral Preferences.

a. The MTC allows the amount of minimum tax liability relating to deferral preferences to be carried forward as a credit against regular tax liability in future years.

2. Exclusion Preferences.

Only four items fall outside of the deferral preference category: (1) percentage-depletion preference; (2) appreciated-property charitable-contribution preference; (3) itemized-deductions; and, (4) tax-exempt preferences.

3. Application and Limitation

MTC is applied against the regular tax liability. It may reduce the regular tax liability to an amount equal to the TMT for that year.

IV. Tax Planning Under The New Law

A. Introduction

Under current law, where planning for the alternative minimum tax (AMT) is a concern, the client's tax affairs are arranged to equalize the AMT and regular tax. This is accomplished by proper timing of transactions that generate tax preference income, e.g., an exercise of an ISO, electing alternative tax methods such as the straight-line method of depreciation, or deferring non-AMT deductions such as state income taxes. Planning within this framework assumes sufficient flexibility to avoid the AMT. The spread between the AMT rate and the 50 percent marginal rate is used to the client's advantage in certain situations. That is, the 30 percent rate spread (assuming a 50 percent rate in the subsequent year) is viewed as a permanent tax savings. Thus, accelerating ordinary income and/or deferring deductions will result in permanent tax savings, discounted by the negative cash flow associated with the one year acceleration of tax. This planning concept will remain important in 1986 and 1987. However, with the tax brackets narrowing and the introduction of the minimum tax credit (MTC) concept, the permanent tax savings associated with the equalization objective will effectively disappear after 1987.

B. Three Scenarios

Any 1986 AMT strategy should not be implemented without considering both tax and non-tax factors. Below are 3 scenarios and related planning ideas:

1. Regular Tax in 1986 and AMT Position in 1987

- a. Accelerate deductions in 1986, particularly those which are not allowed for AMT purposes (e.g., prepaying taxes or miscellaneous deductions).
- b. Defer ordinary income to 1987 (e.g., deferred compensation arrangements).
- c. Accelerate realization of long-term capital gains, taking advantage of the expiring capital gain deduction.
 - i. On the surface, this could be viewed as primarily a nontax decision because the marginal rate is almost the same in both years (20 percent in 1986 and 21 percent in 1987). However, the disadvantages of waiting until 1987 to incur the gain is that you would increase regular tax at a 28 percent rate which reduces the spread between tentative minimum tax (TMT) and regular tax, thus reducing the 1987 MTC. In effect, this means that the gain will ultimately result in a 28 percent tax cost when the reduced MTC is used to offset regular tax in a subsequent year. Thus, there is a 7 percent spread between the ultimate 28 percent tax cost, if sold in 1987, and the sale of 20 percent in 1986, versus the negative cash flow associated with realizing the capital gain in 1986.
- d. Accelerate the exercise of ISOs, as long as the bargain element does not put the client into an AMT position in 1986.

- e. Defer realization of short-term capital gains and accelerate realization of short-term capital losses which can be offset against existing short-term capital gains or \$3,000 of ordinary income.

2. AMT Position in 1986 and Regular Tax in 1987

- a. Defer until 1987 the payment of items which can be claimed as deductions under the new law. Payment in 1986 will yield a smaller tax benefit if deductible for AMT purposes (e.g., charitable contributions) or will waste prospective deductions if not deductible for AMT purposes (e.g., state taxes).
- b. Accelerate ordinary income into 1986 to the extent AMT is equalized with regular tax.
- c. Accelerate realization of long-term or short-term capital gains, and thus be taxed at the lower AMT rate in 1986. The 7 percent rate advantage has to be weighted against the reduced cash flow in making the decision.
- d. Defer realization of a short-term or long-term capital loss, if it can be used against either capital gains or \$3,000 of ordinary income in 1987.
- e. Defer the contemplated exercise of an incentive stock option (ISO) until 1987. The deferral would avoid the 20 percent AMT on the bargain element in 1986.
- f. If the client has already exercised an ISO in 1986, consider having him make a disqualifying disposition of the stock in 1986. The disposition removes the bargain element from the "tax preference taint" in 1986, and since AMT is operative, the entire gain on the sale will be taxed at the 20 percent rate. This planning maneuver eliminates the double taxation of the bargain element, that is,

once as a tax preference in determining AMT in 1986, and then in 1987 as part of the presumed gain on the sale, taxed at the 28 percent rate.

- i. Under this scenario, an exercise in 1986 without a disqualifying disposition guarantees a double tax on the bargain element, assuming appreciation of the stock.
- ii. A disqualifying disposition, however, cannot be made without considering nontax factors, such as the SEC's "Insider Rule 16(b)" and the impact the disposition would have on management and other stockholders.

3. AMT Position in Both Years

- a. With the AMT rate being 20 percent in 1986 and 21 percent in 1987, the acceleration or deferral of income or deductions has little direct tax impact if the transactions do not put the client back into a regular tax position, except with respect to the 1987 MTC. Any transaction that either reduces the 1987 regular tax or increases the 1987 TMT will increase the 1987 MTC. Thus, although you may pay more AMT in 1987, some, if not all, of that payment will eventually be refunded via the MTC offset against regular tax.
 - i. For example, an exercise of an ISO will produce 20 percent AMT in 1986 and 21 percent AMT in 1987. However, exercising in 1987 will not only defer payment of AMT for 1 year on the tax preference, it also will increase TMT, which in this case will increase the MTC by the same amount. Thus, although AMT will be paid in 1987 on the bargain element, an MTC will be available to offset regular tax in future years. The same cannot be said of the AMT paid on the bargain element of the exercised ISO in 1986.

V. APPENDIX

Example 1:

Appreciated Property Charitable Deduction

1. For purposes of the regular tax, appreciated property may still be contributed at its FMV if long-term capital gain property.
2. This benefit, however, is limited by its inclusion as a preference item for AMT purposes.
3. How much this will injure charitable giving is uncertain, but its effect will probably be significant.
4. Example: Assume taxpayer contributes to his church stock with a FMV of \$10,000 that he purchased over 6 months ago for \$2,000. Under both current law and the new tax bill, he can receive a tax deduction for the full FMV with no recognition of gain. Under current law, it will effectively cost the taxpayer in the maximum tax bracket (50%) only \$3,400 to contribute the \$10,000 of stock after accounting for ordinary tax reduction based upon the FMV of the stock and the imputed benefits from the nonrecognition of gain.

Regular Tax

<p>\$10,000 <u>- 5,000</u> 5,000 <u>- 1,600*</u> <u>\$ 3,400</u></p>	<p>Contribute <u>Deduction</u> (50% taxpayer) Cost of donation Additional savings from non-recognition of gain <u>on disposal</u> <u>Total "cost" to donor</u></p>
--	--

<p>*\$10,000 <u>- 2,000</u> 8,000 <u>- 4,800</u> 3,200 <u>50%</u> <u>\$ 1,600</u></p>	<p>FMV <u>Basis</u> LTCG <u>Deduction</u> Taxable gain <u>Tax rate</u> <u>Tax on gain</u></p>
---	---

There is currently no tax preference for the gift, but, under the new tax bill, both the regular tax and the AMT must be considered:

Regular tax

\$10,000	Contribution
<u>- 2,800</u>	<u>Deduction (28% taxpayer)</u>
7,200	Cost of donation
- 2,240*	Additional savings from non-recognition of gain on disposal
<hr/>	<hr/>
<u>\$ 4,960</u>	<u>Total "cost" to donor</u>

*\$10,000	FMV
<u>- 2,000</u>	<u>Basis</u>
8,000	LTCG (no special deduction)
<u>.28</u>	<u>Tax rate</u>
<u>\$ 2,240</u>	<u>Tax on gain</u>

Thus, it will cost this taxpayer of appreciated stock at least 46% more under the new tax law than under the current system to contribute the same property (\$3,400 vs. \$4,960) and he will incur a tax preference item of \$8,000.

Example 2:

Disqualifying Disposition of ISO

1. Both the current law and the Tax Reform Act of 1986 include the bargain element of an exercised ISO as a tax preference item for AMT purposes.
2. However, the new tax law treats the bargain element subject to the preference as a deferral item. The basis of the stock acquired through the exercise of an ISO after 1986 is the FMV at the time the ISO is exercised.
3. For example, if the taxpayer pays an exercise price of \$8 to purchase stock having a FMV of \$16, then the preference in the year of exercise is equal to \$8 and the stock has a basis of \$8 for regular tax purposes and \$16 for minimum tax purposes. If, in a subsequent year, the taxpayer sells the stock for \$20, the gain recognized is \$12 for regular tax purposes and \$4 for minimum tax purposes.
4. A taxpayer in a regular tax position in 1986 should accelerate the exercise of ISOs, as long as the bargain element does not put him in a AMT position.
5. If the taxpayer is already in an AMT position, he should consider making a disqualifying disposition of the stock in 1986.
 - a. A disqualifying disposition will remove the bargain element from the "tax preference taint" in 1986.
 - b. If the taxpayer is still in an AMT position from his other preference items, then the entire gain will be taxed at the flat AMT rate of 20 percent.
 - o in the above example, if the stock is sold for \$20, the taxpayer will incur a tax liability of \$2.40, i.e. $(20-8) \times 20\% = \$2.40$.
 - c. This may remove him from the AMT position, and he will be taxed on the gain.
 - i. If the disqualifying disposition in 1986 occurs within 6 months after the exercise of the ISO, then the full gain will be taxed at the regular tax rate.
 - o in the above example, if the stock is sold for \$20 and the taxpayer is in a 50 percent tax bracket he will incur a tax liability of \$6, i.e. $(20-8) \times 50\% = \$6$

ii. If the disqualifying disposition in 1986 occurs 6 months or more after the exercise of the ISO, then the bargain element from the "tax preference taint" will be taxed as ordinary income, but the additional appreciation will be taxed as long-term gain, subject to the capital gains deduction.

o thus, the taxpayer will incur a tax liability of \$4.80

$$[(\$16-8) + .4 (\$20-16)] \times 50\% = \$4.80$$

6. If the taxpayer waits until 1987 to dispose of the stock, he will be subject to the Tax Reform Act of 1986.

a. If he was in an AMT position in 1986, he will be subject to a double tax since he will be taxed on the bargain element as a tax preference in 1986 and again at the time of disposal of the stock in 1987.

7. Assuming the taxpayer is in a regular tax position in 1987, and he has held the stock for less than 6 months after the exercise of the ISO, then he must pay tax on the bargain element in 1986 and the gain in 1987. The full gain will be taxed at the transitional regular rate of 38.5%. Thus, the total tax to the taxpayer is \$6.22.

o

1986:	(\$16-8) x .2	= \$1.60
1987:	(\$20-8) x .385	= <u>4.62</u>
		\$6.22

a. If the taxpayer has held the stock for more than six months but within one year after the exercise of the ISO, then the portion of his gain that would, under the current law in 1986, be subject to the capital gains deduction will now be subject to a tax rate of 28%. Thus, the total tax to the taxpayer is \$5.80.

o

1986:		\$1.60
1987:	(\$16-8) x .385	= 3.08
	(\$20-10) x .28	= <u>1.12</u>
		\$5.80

