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ALTERNATIVE MINIMUM TAX: WHEN DOES IT SPOIL THE JOY OF GIVING?

BY

ALAN R. CERF

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WHEN DOES IT SPOIL THE JOY OF GIVING?

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Working Paper #88-145

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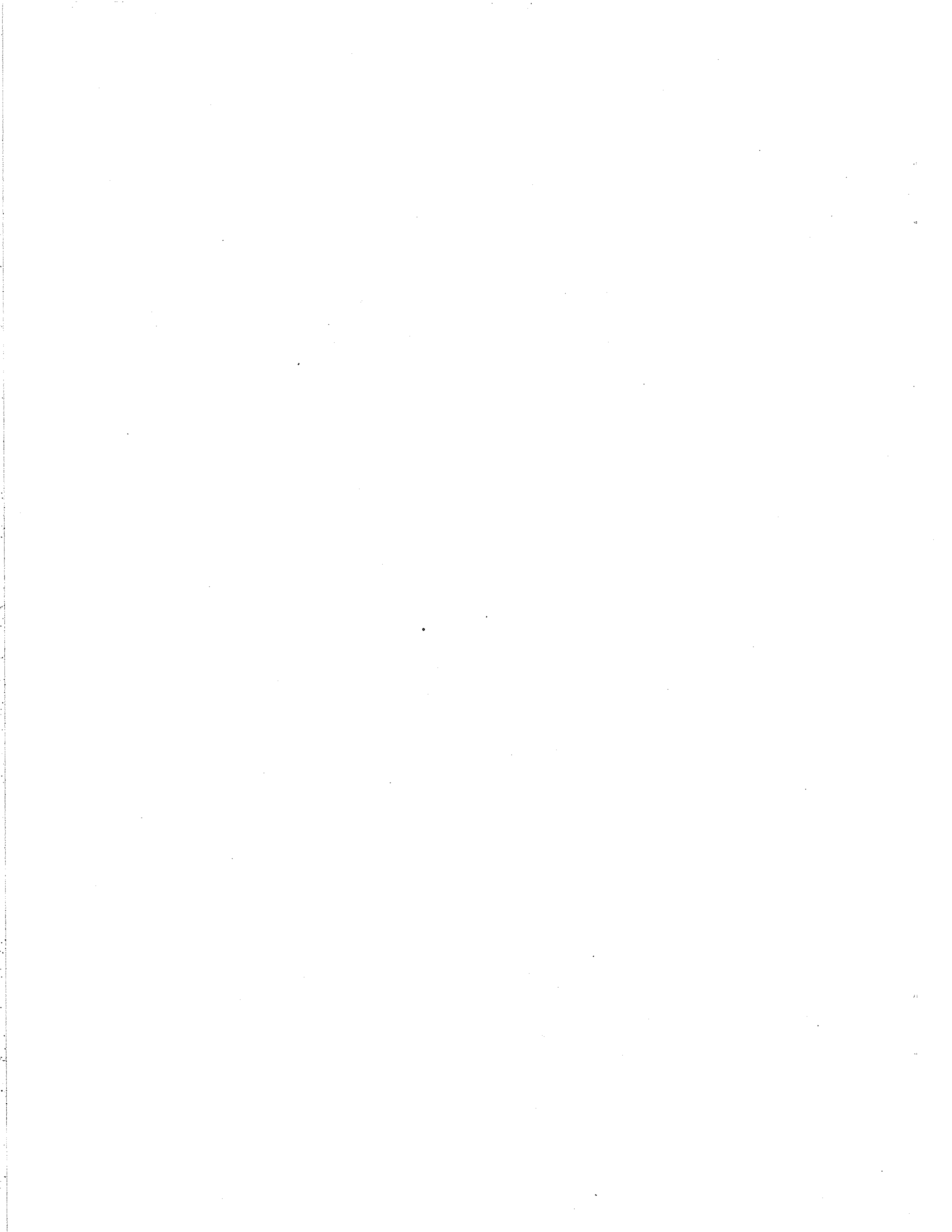


ABSTRACT

THE ALTERNATIVE MINIMUM TAX:

WHEN DOES IT SPOIL THE JOY OF GIVING?

by

ALAN R. CERF

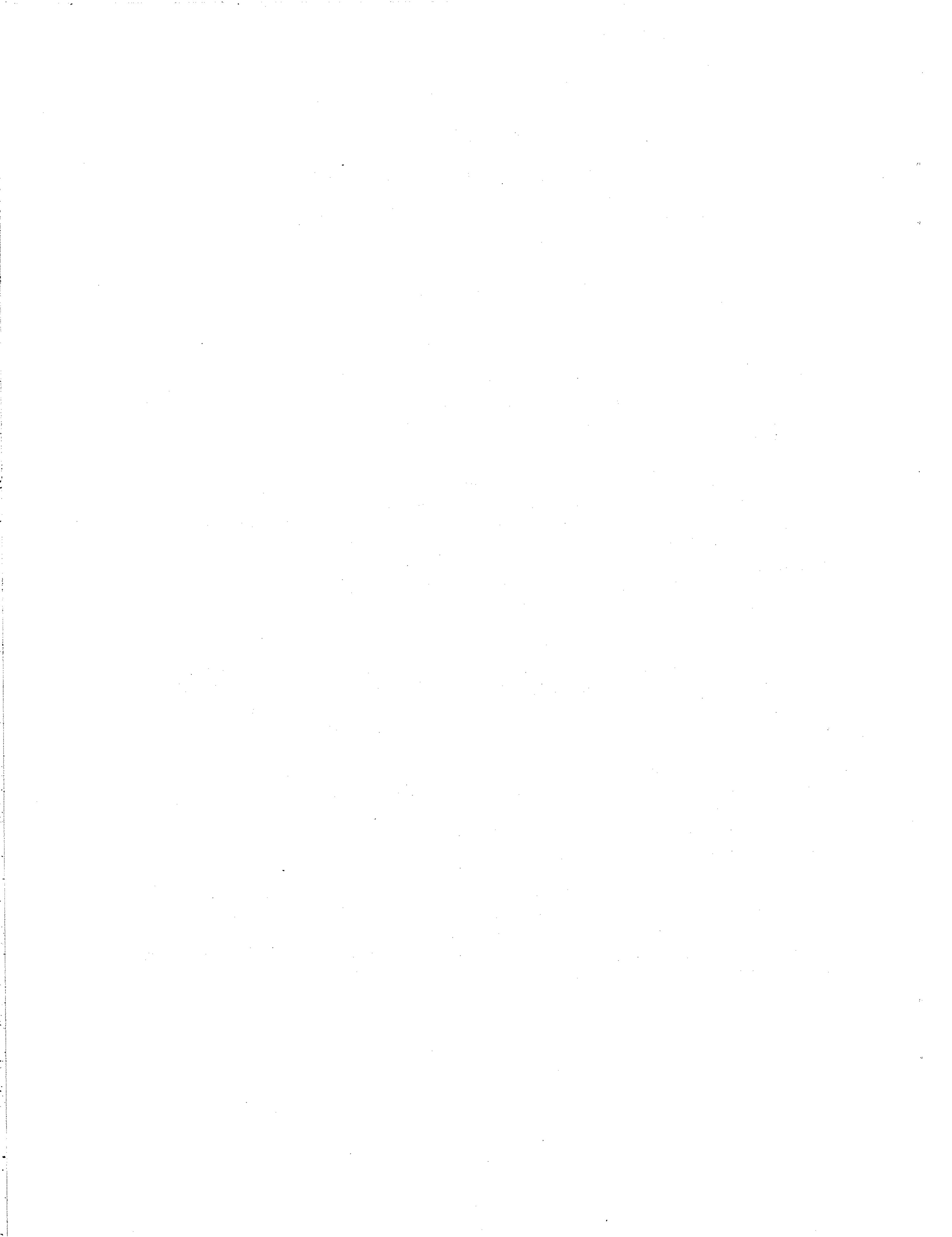
Federal tax policy encourages gifts to charitable organizations by allowing deductions for federal income tax and for federal estate and gift tax. The ability to deduct contributions of appreciated property at fair market value rather than cost is a significant incentive for such contributions. Even though there are limitations on such gifts as a function of the taxpayer's adjusted gross income, gifts of appreciated property are often superior to cash contributions.

The 1986 Tax Reform Act (TRA) made a number of changes that impact charitable contributions. Ordinary tax rates have been lowered thereby generally increasing the after tax cost of contributions. Capital gain rates for the highest tax bracket individuals have increased from 20% to 28% which tends to increase the benefit of giving appreciated property when fair market value can be deducted. The alternative minimum tax (AMT) in effect results in the deduction of contributions of appreciated property at the adjusted basis of the property rather than fair market value if the taxpayer is in the AMT status.

The purpose of the article is to explain the tax impacts for individual taxpayers of charitable gifts of appreciated capital gain property after the tax changes in the TRA. Particular attention is given to the operations of the AMT and how the AMT must be considered in gifts of appreciated long term capital gain property.

A taxpayer must determine whether he or she is likely to be in an AMT status when contemplating a gift of appreciated property. This is a function of the amount of tax preferences and adjustments to income that are required to be made in computing AMT. The contribution itself may place a taxpayer in an AMT status if there is significant appreciation in the property.

Planning possibilities for timing of gifts of appreciated property are discussed. When a taxpayer is in an AMT status in one year and a regular tax status in another year it is important to time the contribution. Since most individuals are cash basis taxpayers there may be opportunities to time other transactions which influence whether a taxpayer will be in a regular or an AMT status.



Introduction

Benefactors of public charities have often made gifts of appreciated property rather than cash contributions because of tax considerations. Income tax deductions for contributions of property as well as estate tax deductions serve to encourage contributions. The ability to avoid the tax on appreciation of property through gifts generally makes contributions of long term capital gain property superior to cash contributions.

The 1986 Tax Reform Act (TRA) made a number of changes that impact charitable contributions. (1) Ordinary tax rates have been lowered thereby generally increasing the after tax cost of contributions. Capital gain rates for the highest tax bracket individuals have increased from 20% to 28% which tends to increase the benefit of giving appreciated property when fair market value can be deducted. The alternative minimum tax (AMT) in effect results in the deduction of contributions of appreciated property at the adjusted basis of the property rather than fair market value if the taxpayers is in the AMT status.

Objectives

The purpose of the article is to explain the tax impacts for individual taxpayers of charitable gifts of appreciated capital gain property after the tax changes in the TRA. Particular attention is given to the operations of the AMT and how the AMT must be considered in gifts of appreciated long term capital gain property. The sale or taxable exchange of capital assets yields capital gain or loss. If the asset has been held in excess of one year this gain or loss is considered long term.

This article does not cover corporate gifts. It also does not discuss the opportunities for individual taxpayers to make a charitable contribution of appreciated property to a charity and retain a life time interest in the property.

Scope of Article

Basic tax rules for contributions are discussed followed by examples of application of the 50% and 30% limits on contributions. The AMT as amended by the TRA is introduced and examples are given of how it is applied. The factors that influence the after tax cost of a contribution when a taxpayer is in an AMT status are set out. Deferral and exclusion preferences and differences between itemized deductions for regular tax and for AMT are explained. The application of the AMT credit is described.

A comprehensive example is given when a taxpayer has both exclusion and deferral preferences. The impact of the 30% limit on the AMT computation is explained. The last section provides examples of planning possibilities for timing of contributions. When a taxpayer is in an AMT status in one year and a regular tax status in another year it is important to time contributions of appreciated property. Since most individuals are cash basis taxpayers there may be opportunities to time other transactions which influence whether a taxpayer will be in a regular or an AMT status.

The 1986 tax reform act reduced individual tax rates and thereby increased the after tax cost of gifts. A taxpayer in the highest marginal bracket pays a marginal rate of 28% on income compared to 38.5% in 1987 and 50% in 1986. Some taxpayers pay a marginal rate of 33% in 1988 because of the recovery of the benefits of the 15% rate on low levels of income and recovery of the benefits of personal exemptions. The after tax cost of a contribution is much larger under the current law than under prior law.

Consider Bill Bear who has taxable income of $100,000 and wishes to give the University of California $10,000 for the capital improvement program. Bill is married and is in a 33% marginal bracket in 1988. The net cost of his gift is $6,667. In 1986 the net cost would have been $5,000.(2)

Capital gains are now taxed at the same rate as ordinary income. A taxpayer in the highest marginal bracket now pays 28% on capital gains. If she is in the 33% marginal bracket she would pay 33% on the capital gain. A taxpayer in 1986 would have paid a maximum marginal rate of 20% on long term capital gains. This is important because an individual contemplating a gift of appreciated property may possibly avoid the tax on capital gains through the gift.

A negative in the TRA is the inclusion of the appreciation element in contributions as a tax preference for the alternative minimum tax (AMT). The AMT provides for an increase in the tax base as a result of certain adjustments and preferences. A tax is computed at 21% of the new tax base. If the AMT tax is higher than the regular tax a taxpayer must pay the higher tax. An AMT credit is computed which is used if a taxpayer returns to a regular tax status sometime in the future. The determination of the AMT is complex and is discussed in detail later in the article.

Is It Better to Give Cash or Appreciated Property?

It is generally preferable to give appreciated property than an equal amount of cash. It is better to give the property than to sell the property and give the proceeds. The reason is that capital gain on the appreciation element is avoided. This assumes that the taxpayer is not subject to the AMT.

To illustrate this take the situation of Bill and Gwendolyn Bear who have taxable income of $200,000 in 1988 before any charitable contributions. They are not subject to

the AMT. They wish to give $50,000 to the Berkeley Business School for its new building. They have appreciated capital gain property with a cost of $10,000 and fair market value of $50,000. They are considering whether they should make a gift of the property, sell the property and give the proceeds to the school, or give a cash contribution. The results of this comparison are shown in Table I.

Table I

Tax Results of Decision of Giving Cash or Appreciated Property

	Cash	Gift of Property	Sale of Property-Give Proceeds
Taxable Income	$200,000	$200,000	$200,000
Deduction	(50,000)	(50,000)	(50,000)
Long Term Capital Gain			40,000
Taxable Income	150,000	150,000	190,000
Tax	42,038	42,038	54,292

Bill and Gwendolyn pay $12,254 more tax if they sell the property and give the proceeds. They would also have to make this difference up with cash from other sources to give the University the $50,000. If they give cash they are giving a previously taxed asset and keeping appreciated property on which tax has not yet been paid.

Limits on Deductibility of Contributions

There are several percentage limits which determine the amount of contribution deduction an individual can take in the year of contribution. The limitation is a function of the tax classification of the donee organization, and the tax classification of the property given. In some situations the use of the property by the donee is relevant.

50 Percent Limit

There is an overall maximum allowable deduction in any year for charitable contributions by an individual taxpayer of 50% of the contribution base. The contribution base is adjusted gross income computed without regard to any net operating loss carryback to the year [IRC Sec.170(b)(1)(f)]. As discussed below other limitations may apply which limit the deduction further.

For example, this limitation does not apply to contributions of appreciated long term capital gain property where the deduction is based on fair market value.

The 50% limit applies primarily to public charities. The organizations receive their status under the law. Organization that meet these requirements are generally engaged in charitable, religious and education activities. Universities such as the University of California falls in this category. The IRS publishes the Cumulative List of Organizations which contains a list of tax exempt organizations. Donees are not required to be included in this publication. Characteristics of qualifying donees are described in IRC section 170(c).

Contributions to "private nonoperating foundations" are subject to further restrictions. These organizations are described in IRC Section 509(a).

Classification of Property for 50 Percent Limit

An individual contemplating a gift may consider the merits of giving different types of property. For example a donee may wish to give the University $10,000. Is it better to give cash, or appreciated property? A gift of cash or property which if sold on the date of contribution would yield ordinary income is subject to the 50% limit.

To illustrate assume Goldie Bear wishes to give the Berkeley Business School 100 shares of a Utility stock. The stock was purchased ten months ago for $40,000 and at the date of contribution had a fair market value of $60,000. Goldie's adjusted gross income is $100,000. The charitable deduction allowable is $40,000 which is equal to the adjusted basis of the stock. The amount of the contribution is under Goldie's limit of $50,000 (50% of $100,000 adjusted gross income). Since the stock is short term capital gain property it would have yielded ordinary income on sale. The stock was held for less than one year which is required for classification as long term capital gain property.

Application of 30% Limit-Long Term Capital Gain Property

An individual may desire to make a gift to a public charity of appreciated long term capital gain property. The general rule is that such contributions are deductible at their full market value. These contributions do not qualify for the 50% of adjusted gross income limits. Contributions are deductible only to the extent of 30% of adjusted gross income [IRC Sec. 170(b)(1)(c)(i)].

Bill Bear had adjusted gross income of $30,000 for the current tax year. The only contribution made by Bill consisted of a utility stock worth $10,000 which he purchased for $4,000 in 1985. The stock was given to the University. Bill's deduction is limited to $9,000 (30% of $30,000 AGI) because the stock is long term capital gain property. The $1,000 excess contribution can be carried over and deducted in subsequent years. Note

that his deduction is based on fair market value but the current year deduction is limited to 30% of AGI rather than 50%.

Consider how the limits work if there are gifts of long term capital gain property and other property in the same year. This will be illustrated by assuming the same information as in the above example except that Bill's adjusted gross income was $40,000 and he also gave $14,000 cash to Stanford. The deduction for the gift of the stock is limited to $6,000. The 50 percent overall limits is applied before the 30 percent limit (50% x $40,000 AGI = $20,000). The cash contribution uses $14,000 of the limit which leaves a balance of $6,000. Bill has a carry-over of $4,000 which is the difference between the fair market value of stock and the $6,000 deduction allowed.(3)

Alternative Rule for Long Term Capital Gain Property

The 30 percent limit can be avoided if the taxpayer elects to reduce his or her claimed deduction for the capital gain property [IRC Sec. 170(b)(1)(C)(iii)]. In some situations this could yield a larger deduction in the current year. An individual must of course consider the current year deduction and the carry-over. Note that such an election applies to all contributions of capital gain property made during the year.

Assume Bill had adjusted gross income of $50,000 for the current year. He contributes long term capital gain property worth $23,000 to the University of California. Bill purchased the property for $19,000 five year earlier. This is his only contribution for the year.

Bill has two choices. He can use the 30% of AGI limit or he can reduce the deduction by the unrealized appreciation on the capital gain property and forego any carry-over.

Using the 30 per cent limit the current deduction is $15,000 (30% of $50,000 AGI) Bill still has a carry-over of $8,000 ($23,000 fair market value - $15,000 deduction).

Bill could instead use the 50 percent limit and his current deduction would be $19,000 which is his adjusted basis for the property. He does not have a carry-over in this case since he has used the entire adjusted basis of $19,000.

Using the election Bill has $4,000 more current deduction ($19,000 - $15,000) but his total deduction is $23,000 using the 30 % limit versus $19,000 using the 50% limit. Is the additional $4,000 current deduction worth more than the present value of $8,000 deferred to the future?

If there is little appreciation in the property it might be desirable to currently deduct the adjusted basis of the property so as to take advantage of the 50% of AGI limit. Other factors to consider include the difference between the taxpayer's current and future marginal tax rates and whether there is uncertainty as to the use of the carry-over because of a donor's health or advanced age.

Carry-over Rules

An individual's contribution which exceeds the percentage limits may be carried over for five years [IRC Sec. 170(d)(1)(A), Reg. Sec. 1.170A-10((a)]. Excess contributions due to the 20 and 30 percent limits will again be subject to these limits in the carry-over years. Contribution carry-overs are treated as having been made in the year to which they are carried. Contributions that were actually made in the carry-over year are claimed before any carry-over amounts are deducted.

In 1988 Bonnie Bear contributed $10,000 cash to the University of California. Her adjusted gross income for 1988 is $15,000 so Bonnie's contribution deduction for 1988 is limited to $7,500 (50% of $15,000 AGI). Bonnie may carry-over the remaining $2,500 to 1989. If she does not make contributions in 1989 which exceed the 50 percent limits she can claim the $2,500 as a deduction. If contributions actually made in 1989 exceed 50 percent of her 1989 adjusted gross income, she must carry-over the 1989 excess contributions and the $2,500 carry-over from 1988.

Change the above example and assume Bonnie's contribution was long term capital gain property with a fair market value of $10,000. Her 1988 deduction would be limited to $4,500 (30% of $15,000 AGI) and she would have a $5,500 contribution carry-over. This carry-over resulted from the 30 percent limit and such is subject to the 30 percent limit in any carry-over year. If she has AGI of $10,000 and does not make contributions in 1989, she can claim a deduction of $3,000 (30% of $10,000 AGI) The remaining $2,500 would be carried over.

All charitable contribution carry-overs are applied on first-in, first out basis in determining the amount of any carry-overs deductible in the current year. A taxpayer with contribution carry-overs must be careful to avoid loss of these carryforwards.

Donations to Private Nonoperating Foundations and Private Charities

The deduction for donations of cash and ordinary income property to private nonoperating foundations is also subject to a limit of 30% of AGI. These charities are sometimes referred to as 30% charities as contrasted to the public charities which are referred to as 50% charities. The 30% limit applies to most contributions of capital gain property and to contributions of cash and ordinary income property to nonqualifying private nonoperating funds. A more severe restriction is imposed on deductions for

contributions of capital gain property to such private nonoperating foundations. These restrictions will not be considered here. The reader is referred to IRC Sec. 170(b)1)(B)(i).

ALTERNATIVE MINIMUM TAX

The untaxed appreciation in charitable contributions of appreciated capital gain property is a preference item for the alternative minimum tax (AMT). This means for AMT purposes a taxpayer can deduct only the adjusted basis of the property. Therefore the AMT can sometimes diminish the tax benefits of contributions of appreciated capital gain property. A taxpayer contemplating such a gift must consider his(her) exposure to this tax.

Congress added the minimum tax in 1976 and since then it has grown in scope and importance. This was because many high income taxpayers were able to pay tax at effective rates significantly below regular tax rates. This was done through using investments that were preferred under the law. The tax reform act of 1986 (TRA) revised the minimum tax rules. As a result it is even more difficult than before for taxpayers to avoid tax through the use of certain tax preferences.

The purpose of the minimum tax is to ensure that no taxpayer with substantial economic income can avoid significant tax liability by using exclusions, deductions and credits. Taxpayers must make a completely separate tax calculation to determine the tentative minimum tax. If the tentative minimum tax is greater than the regular tax liability the taxpayer will have to pay the higher tax.

A separate tax calculation is required to determine the alternative minimum taxable income (AMTI). A new and broader base is calculated by making adjustments to regular

taxable income for those items that are considered to receive preferred treatment under the regular system. AMTI is taxable income for regular tax purposes increased or decreased by certain adjustments, and increased by tax preference items and decreased by an exemption. The purpose of the adjustments is to require use of different methods of accounting for AMTI purposes. An example is depreciation where different methods and different recovery periods are required for AMT purposes. Tax preferences are certain designated deductions that reduce regular taxable income. They are added back for AMTI purposes. In addition itemized deductions for AMTI are much more limited than for regular tax purposes. Tax Preferences are detailed in Appendix I. Adjustments and certain loss disallowances for AMTI are explained in Appendix II.

For joint returns, a $40,000 exemption is provided to eliminate the need for many middle income taxpayers to compute the AMT. The exemption is $30,000 for unmarried taxpayers and $20,000 for married taxpayers filing separate returns.

The exemption is phased out for higher income taxpayers. It is reduced by 25% of the amount by which AMTI exceeds $150,000 for married taxpayers filing jointly and $112,500 for unmarried taxpayers. The phase out begins at $75,000 for married taxpayers filing separately.

The TRA increased the AMT rate for individuals from 20% to 21% and also greatly broadened the AMT base. As a result, many individuals who were never subject to the minimum tax now may find themselves subject to it. Additional preference items in the new law included: (1) untaxed appreciation of contributions of appreciated property, (2) tax exempt interest on certain bonds, (3) passive activity losses allowed during the phase out period, (4) depreciation on personal property, (5) deferred income under the completed contract method of accounting, (6) deferred installment sale income.

Many individuals who are in the position of donating appreciated capital gain property may also have tax preferences as a result of tax exempt interest and passive activity losses. More individuals than before are subject to the AMT because there is only a slight difference between the AMT rate and the regular tax rate and the tax base of the AMT is so much larger. Thus a taxpayer needs relatively small amounts of tax preferences to find that his minimum tax at a 21% AMT rate is higher than his regular tax at a 28% rate. Because state income taxes are not deductible in computing AMTI, taxpayers living in high tax states may be pushed into the AMT status by that fact alone.

Preference For Untaxed Appreciation of Charitable Contributions

A taxpayer who makes a charitable contribution of appreciated capital gain property has a tax preference for AMT purposes. The preference amount is the amount by which the charitable contribution claimed for regular tax purposes exceeds the property's adjusted basis. The net result is that a taxpayer receives a different and lower deduction for AMTI purposes (adjusted basis) than for regular tax purposes (fair market value).

For example Oski Bear donated IBM stock worth $10,000 to the Berkeley Business School which he purchased three years ago for $6,000. Assume Oski deducted the property's fair market value of $10,000 for regular tax purposes. Oski has a tax preference item of $4,000 as a result of the contribution claimed for capital gain property. This is the fair market value of $10,000 less the adjusted basis of $6,000. How this preference impacts the AMT is shown in Table II.

Facts for Table II

To illustrate the computation of the alternative minimum tax and how it is impacted by the contribution tax preference we will assume Oski is a married taxpayer. Oski and Goldie Bear file a joint tax return. Because of large itemized deductions for medical expenses, property taxes, deductible interest expenses, contributions, and allowable casualty losses and miscellaneous itemized deductions their taxable income is zero and they have no regular tax to pay.

To compute the alternative minimum tax Oski has to add back to income the regular tax itemized deductions but is allowed to subtract AMT itemized deductions. These latter deductions are more limited than regular itemized deductions. For example real and personal property taxes, miscellaneous itemized deductions and the amount of consumer interest that has not been phased out for regular tax purposes is not allowed. Medical expenses are only allowed over a 10 percent rather than the 7.5 percent floor.

The next step is to add back the tax preference amount for the untaxed portion of the charitable contribution. Subtracting the $40,000 exemption for married taxpayers Oski has an AMTI base of $14,000 and at a tax rate of 21% he must pay $2,940 in tax. The amount of the AMT due to the contribution is $840 (21% of $4000).

Table II

COMPUTATION OF ALTERNATIVE MINIMUM TAX

Amount of regular taxable income	0
Add back:	
Regular tax itemized deductions	+95,000
Subtract:	
AMT itemized deductions	-40,000
AMT adjusted taxable income	$50,000
Plus: Tax preference due to charitable contribution ($10,000 FMV - $6,000 adjusted basis)	4,000
Alternative minimum taxable income	$54,000
Less: Exemption	- 40,000
Alternative taxable income base	14,000
Times: AMT rate	x 21%
Gross alternative minimum tax	2,940
Less: AMT foreign tax credit	- 0
Tentative AMT	$2,940
Less: Regular tax liability	0
AMT liability	$2,940

Oski and Goldie are in a 21% tax bracket and they only receive a deduction for the adjusted basis of the asset. The tax benefit of the gift is therefore 21% of $6,000 or $1,260. If they were not in an AMT status the benefit would have been 28% or 33% of the fair market value of the gift. Although the 28% rate is the highest rate for regular tax purposes, a taxpayer pays 33% on marginal income that falls within a range in which the 15% bracket benefits and the personal exemption benefits are being phased out.

Determination of value of Contribution

The benefit of a charitable contribution under the new law depends on whether the taxpayer is subject to the AMT. It also depends on whether it is ordinary or appreciated capital gain property and whether the taxpayer is in a regular tax status in one year and the AMT status in another year. It also depends on the mix of adjustments and tax preferences. A taxpayer giving $20,000 to the Berkeley Business School would receive a benefit of $5,600 (28% of $20,000) under the regular tax system. However under the AMT the benefit would only be $4,200 (21% of $20,000) Eventually the benefit might be $5,600 under the AMT through the operation of the AMT credit described shortly.

If the contribution is made with appreciated long term capital gain property the differences may be more substantial. For example consider a gift of appreciated capital gain property with a basis of $10,000 and a fair market value of $20,000. If the taxpayer is subject to regular tax the current benefit of the contribution is $5,600 (28% of the $20,000 value). If the taxpayer is subject to the AMT the benefit is $2,100. This is 21% of the $10,000 basis. The above example is simplified for illustration purposes. The actual result is influenced by a variety of factors including the amount and types of the taxpayer's tax preferences, the difference between the fair market value and cost of

the property, and whether the taxpayer alternates between the regular tax system and the AMT system.

Alternative Minimum Tax Credit

A taxpayer may be in a regular tax status in one year and the AMT tax status in another year. In order to avoid potential double tax of certain items when there is a shift from the regular to AMT status the AMT credit was established.

The AMT credit is the excess of the AMT tax liability over the regular tax liability. This difference is a function of timing differences and exclusion preferences which will be described below. The AMT credit can not be greater than the amount of deferral preferences. This credit can be used in future periods when taxpayer is in the regular tax status and serves to reduce his or her tax for that year. The AMT credit provides no relief for taxpayers who incur the AMT because of exclusion preferences such as the appreciated portion of contributions of capital gain property. Also if a taxpayer is in an AMT position year after year he cannot use the AMT credit.

There are two classifications of adjustments and preferences. These are exclusion preferences and deferral preferences. Exclusion preferences represent permanent differences between regular taxable income and AMTI. Included is the unrealized gain in contributions of long term capital gain property and other items such as for example certain tax exempt interest, and the deduction for state and local taxes.

Deferral preferences represent temporary differences between regular taxable income and AMTI. They are a function of different timing of income and deductions under the regular tax and AMT systems. For example, the cost of depreciable property is fully recoverable as depreciation under both systems. However the methods of recovery may be different under the regular tax system and under the AMT system. For

deferral preferences the same amount of income and deductions is recognized under both systems. However the time they are allowed differs.

Operation of AMT Credit

A potential contributor of property that is in an AMT status needs to determine both the current and potential future benefit of a contribution. The operations of the future benefit is complex. To illustrate this an example of a cash contribution will be given. This will be followed by an example of a contribution of appreciated property.

Assume that an unmarried taxpayer has $200,000 of regular taxable income for 1988. He also has deferral preferences of $100,000 so that his AMTI is $300,000. He is contemplating a $10,000 cash contribution to the University. What income tax deduction will he get for this $10,000 contribution? The results are summarized in Table III.

Table III

Cash Contribution of $10,000 for Taxpayer in AMT Status

	Before Contribution	After Contribution
Regular Tax	$56,000	$53,200
	(28% of 200,000)	(28% of $190,000)
AMT	$63,000	$60,900
	(21% of $300,000)	(21% of $290,000)
AMT Credit	$7,000	$7,700
	($63,000 - $56,000)	($60,900 - $53,200)

Since the taxpayer is in the AMT status his current benefit is $2,100 which is the difference in AMT liability before and after consideration of the contribution. He now has an additional AMT Credit of $700 which may or may not be useful in the future. If he returns to regular tax status in the future he will be able to offset this $700 against his regular tax liability and thus the total tax benefit will be $2,800 consisting of $2,100 current and $700 somewhere in the future. If however he never returns to a regular tax status the $700 will be useless and his total benefit is only 21%. It is more complicated if the AMT status is due to both deferral and exclusion preferences. Then the future value of the credit will be a function of the mix of the deferral and exclusion credits. In any case the value of the future benefit needs to be discounted because it will not be received currently.

Tax Benefit of Gift of Appreciated Property When in AMT Status

If appreciated property is given the operation of the credit becomes more complex. The result depends on the mix of the exclusion and deferral preferences.

Exclusion and Deferral Preferences

The AMT is calculated the normal way. Assume the result was $50,000. Then the AMT is calculated again considering only itemized deductions, percentage depletion, tax exempt interest and appreciated property charitable deductions. Assume this came out to be $35,000 because there were additional preferences other than those noted. The AMT credit in this case is the difference between the regular AMT and the AMT calculated with only the specified adjustments. The difference of $15,000 ($50,000 - $35,000) is the amount that can be carried forward and used against regular tax in the future.

Comprehensive Example Given Deferral and Exclusion Preferences

A more complex example will be used to illustrate the AMT credit with both types of preferences are present. Assume married taxpayers with gross income of $200,000. State income taxes amount to $30,000 and real property taxes $10,000. They have deferral preferences of $95,000 and a loss from tax shelter of $100,000. They give the University appreciated property that has a $5,000 adjusted basis but has appreciated to $35,000 in value.

To determine the results of this gift it is necessary to calculate the regular tax, the alternative minimum tax and the alternative minimum tax credit. Regular tax amounts to $19,272.50 as calculated in Table IV. Note that only 40% of the passive loss is allowed in 1988. The charitable contribution is deducted at fair market value.

Table IV

Calculation of Regular Tax

Gross Income	$200,000
Tax Shelter Loss $100,000	(40,000)
Adjusted Gross Income	160,000
Property Tax	(10,000)
State Income Tax	(30,000)
Charitable Contributions	(35,000)
Exemptions	(3,900)
Taxable Income	$81,100
Tax Liability	$19,272.50

Table V shows the calculation of the AMT. The AMT base is larger than the regular tax base as it is necessary to add back the regular tax itemized deductions and only subtract the specified AMT itemized deductions. The passive loss allowable for regular tax purposes is added to the base as is the deferral preference and the long term capital gain portion of the charitable contribution. The $40,000 exemption allowed for married taxpayers is reduced by 25 cents for each $1.00 AMTI exceeds $150,000.

The current benefit of the contribution of the property is $1,050. This is 21% of the property's adjusted basis of $5,000 or $1,050. Whether there is a future benefit will depend on the AMT credit carryforward. This is computed as shown in Table VI. The Adjusted Net Minimum Tax (ANMT) must be determined. This is the regular AMT less the AMT computed using only specified adjustments and preferences. These are itemized deductions, percentage depletion, tax exempt interest and appreciated property charitable deductions.

In summary a taxpayer that is in an AMT status can determine the current income tax deduction resulting from a contemplated gift. The current deduction is limited to their tax basis for AMT purposes. A future benefit may be realized depending on the combination of deferral and exclusion preferences that caused the taxpayer to be in the AMT status. This future benefit results from the operation of the AMT credit which may be used against a future regular tax liability in a year the taxpayer is in a regular tax status rather than in the AMT status. This credit may be carried forward indefinitely until it is used. It cannot be carried back and cannot be used to offset future minimum tax liabilities.

Table V

Calculation of AMT with Deferral and Exclusion Preferences

Taxable Income	$81,100
Regular Tax Itemized Deductions	75,000
Allowed Passive Loss	40,000
	$196,100
AMT Itemized Deductions	(35,000)
AMT Adjusted Taxable Income	$161,100
Plus Tax Preferences	
Long Term Capital Gain Portion of Charitable Contribution	30,000
Deferral Preference	95,000
AMTI	$286,100
Exemption (1)	(5,975)
Tax Base	$280,125
Tax Rate	21%
Tentative AMT	$58,826.25
Regular Tax	19272.50
AMT	$39,553.75

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(1) $40,000 - .25(286,100 - 150,000)

Table VI

Calculation of AMT Credit

Taxable Income	$81,100
Regular Tax Itemized Deductions	75,000
	156,100
AMT Itemized Deductions	(35,000)
AMT Adjusted Taxable Income	121,100
Long Term Capital Gain Portion of Appreciated Property	30,000
AMTI	$151,100
Exemption (1)	39,725
Tax Base	$111,375
Tax Rate	21%
Tentative AMT	23,388.75
Regular Tax	19,272.50
AMT (specified preferences)	$4,116.25
Regular AMT	39,553.75
AMT Credit	$35,437.50

(1) $40,000 - .25(151,100 - 150,000)

The AMT and the 30% Limit

The limit on deductions equal to 30 percent of adjusted gross income (AGI) for appreciated capital gain property was explained earlier in the paper. This limits contributions of long term capital gain property to public charities to 30% of adjusted gross income for regular tax purposes.

The following shows how the deduction for AMT purposes is computed when the deduction for regular tax purposes is limited to 30% of adjusted gross income. Assume that Bear Backer contributes appreciated property to the University of California. The adjusted basis of the property is $90,000 and its fair market value is $150,000. Bear's AGI is $150,000. The charitable deduction for regular tax purposes is limited to $45,000 (30% of $150,000). The carry-over for regular tax purposes is $105,000 ($150,000 - $45,000).

To compute the AMT it is necessary to determine the AMT preference as a result of the contribution. There is no AMT preference until the deduction allowable for regular tax purposes exceeds the property's tax basis.(4) Therefore Bear is allowed the full $45,000 deduction for AMT purposes since it is less than his $90,000 basis. Assume next year Mr. Backer's AGI is $250,000. The deduction for regular tax purposes is limited to $75,000 (30% of $250,000). He now has a tax preference for AMT purposes. This is because he now is getting a deduction for an amount in excess of his basis. In year one he used $45,000 and year two $75,000 or a total of $120,000. This is $30,000 in excess of his $90,000 basis so he has a tax preference in year two of $30,000. He still has a carry-over for regular tax purposes of $30,000. He has used $45,000 in year one and $75,000 in year two or a total of $120,000 of the fair market value of $150,000. When he uses this $30,000 in year three he has a tax preference of

$30,000 for AMT purposes.

The implication for decision making is that a contributor of appreciated capital gain property in which there is substantial appreciation must determine the impact of the contribution on the AMT. Substantial liabilities for AMT might result in both the contribution year and the carry-over years.

Planning Possibilities

Taxpayers considering a gift of appreciated property should attempt to project both their regular taxable income and their AMTI. Preferably this should be done for more than one year. Recall the exemption is subtracted from AMTI to arrive at the AMT base. The exemption is $40,000 for married taxpayers filing joint returns, $30,000 for unmarried taxpayers and $20,000 for married taxpayers filing separate returns. This exemption may prevent a taxpayers from being subject to the AMT.

Higher income taxpayers must consider that the exemption is phased out. It is reduced by 25% of the amount by which AMTI exceeds $150,000 for married filing jointly and $112,500 for unmarried. The phase out begins at $75,000 for married filing separately.

Next the impact of the tax preferences and adjustments as well as the disallowance of certain itemized deductions need to be considered. Tax preferences are set forth in Appendix I. Itemized deductions and losses disallowed for AMT are explained in Appendix II. Once a taxpayer has determined whether they need to be concerned about the AMT certain planning may be possible.

As an example married taxpayers with regular taxable income of $113,700 who claim four personal exemptions in 1988 would need $62,810 in adjustments and preferences before they would be subject to the AMT.

Planning possibilities arise because a taxpayer can determine the year in which to make a contribution. Particular care must be taken for substantial gifts of appreciated capital gain property. Since the appreciation element is a tax preference for AMT purposes contribution of such property can result in substantial liabilities under the AMT.

A taxpayer should plan to time contributions so as to maximize the value of the contribution deduction. If a taxpayer is in a regular tax status in one year and an AMT status in another year it is preferable to give the appreciated property in the regular tax year because the fair market value is deductible up to 30% of AGI. When a taxpayers status moves back and forth between the regular tax and the AMT tax results of alternative contribution timing schemes need to be projected.

Timing Transactions

In addition to the timing of the contribution itself it is often possible to influence the timing of income and deductions which influence whether a taxpayer will be in the regular or the AMT tax status.

Most individuals are cash basis taxpayers. Under the cash basis income is generally recognized in the year received and expenses are deducted in the year paid. Consideration should be given to the cash flow involved in the implementation of the timing transactions, the opportunity cost of earnings on the cash required for early payments, and the present value of the tax savings.

Timing is complicated by the need to hypothesize on future tax rates as well as the future earnings and expenses of the taxpayer.

Timing transactions influences the regular tax computation, the AMT computation and the AMT credit. Taxpayers need to be concerned about the AMT if they have significant tax preferences of if they have substantial regular itemized deductions which

are not deductible for AMT purposes. Appendix I lists tax preferences for AMT purposes. Appendix II lists differences in itemized deductions for regular tax and AMT purposes. Recall that some itemized deductions are deductions for both regular tax purposes and for AMT purposes whereas others are only deductible for regular tax purposes. If a person is in an AMT status in year one and expects to be in a regular tax status in year two, consideration should be given to delaying the deductions that are deductible for both until year two since they will be worth more as a deduction at a higher tax rate.

Deductions that are allowable for regular tax and not for AMT offer superior timing possibilities. These should be timed if possible so that they are paid in a regular tax year or otherwise they may be wasted.

Items that result in tax preferences should be timed when possible so as to avoid the 21 percent tax on the preference. For example the exercise of an ISO should be deferred until the regular tax year if everything else is equal. As noted earlier charitable contributions of appreciated property should be deferred until the regular tax year if possible.

A taxpayer expecting to be in an AMT status in year 2 but not in year one may consider strategies that are reverse of the above. This would include payment of items that are not deductible for the AMT in year one. Items that are deductible for both regular tax and AMT should be deducted in year one. Here the taxpayers cash flow is improved because of the earlier deduction. Consideration should be given to deferring income because the income will be taxed at the lower AMT rate in year two.

Contributions of appreciated property and the exercise of incentive stock options should be accelerated into year one so as to reduce the amount of the tax preference for AMT purposes.

Planning requires projection of results into the future and therefore is subject to all the problems associated with projections. For example a taxpayer may know his income and expenses for the current year at the date of the projections. Next years income and expenses are uncertain as well as tax rates. Many taxpayers that have invested in a variety of investments do not know what their tax preference will be until after the year end. A taxpayer may not be able to determine whether he will be in a regular tax status or AMT status in the next year. Thus planning becomes extremely complicated.

APPENDIX I

TAX PREFERENCES FOR INDIVIDUALS

The objective of this appendix is to provide a general understanding of the major tax preferences. The application of the rules for some are complex and therefore it is desirable to have the help of a tax advisor. Many individuals will find they have tax preferences as the result of their investments. Rental property is a common source as are investments in limited partnerships engaged in rentals, oil and gas drilling, mining, and leasing of personal property.

Charitable Contributions

The preference amount is the amount by which the contribution deducted for regular tax purposes exceeds the adjusted basis of the property. This preference is discussed more fully in the text.

Depreciation

Many taxpayers own rental property or have invested in limited partnerships in which depreciation has been taken under an accelerated depreciation method. Such taxpayers must be concerned with the tax preferences described below.

Taxpayers who use the accelerated cost recovery system ACRS for depreciation purposes for property placed in service after 1986 need to recompute the depreciation deduction for AMT purposes under the alternative depreciation system. This results in the excess of ACRS over the depreciation amount calculated under the alternative method being treated as a tax preference. Since the ACRS depreciation is larger the effect is to increase the AMT tax base.

The alternative depreciation system generally requires the use of the straight line method, and a 40 year depreciation life for real property and 150 percent declining balance method for personal property computed over the class life of the property.

Real property placed in service prior to 1986 was depreciated under a 15 ,18, or 19 year life using either an accelerated method or a straight line method. If a taxpayer is using an accelerated method there is a tax preference for the difference of depreciation for regular tax purposes and depreciation computed using the straight line method, and no salvage value. Taxpayers that own rental housing need to consider this tax preference.

Excess accelerated depreciation on leased personal property is a tax preference. The preference is the depreciation taken for regular tax purposes less the depreciation taken if the straight line method had been used with no salvage value and specified recovery periods were used. Excess accelerated depreciation on low-income housing is a preference. The straight line recovery period is 15 years.

Research and Experimentation Costs

The tax deduction for the current year for regular taxes minus the deduction that would be allowed if these costs were amortized over a 10 year period is a tax preference.

Incentive Stock Options

A tax preference arises when an individual taxpayer purchases an incentive stock option at less than the stock's fair market value. The preference is the difference between the fair market value at time of purchase and the purchase price. If the stock is disposed of in the option year, it is not a preference item.

Tax Exempt Interest

The preference relates to interest income on specified private activity bonds issued after August 7,1986. (IRC 57(a)(5)(C)(iv). Private activity bonds are bonds issued if 10 percent of the proceeds of the issue are used for private business use in any trade or business carried on by any person that is not a governmental unit. If tax exempt interest is required to be included for minimum tax purposes than deductions for expenses and interest relating to tax exempt income are allowed for minimum tax purposes. Normally IRC 265 denies expenses and interest incurred in acquiring tax exempt income.

Depletion in Excess of Basis

Taxpayers receive deductions for depletion in respect to natural resources. The tax preference is the excess of the percentage depletion claimed for the taxable year over the adjusted basis of the property at the end of the taxable year.

Intangible Drilling Costs

The amount of tax preference is equal to the intangible drilling costs incurred on productive oil, gas, and geothermal wells reduced by the sum of: (a) the amount allowed as if the IDCs had been capitalized and amortized over a 10 year period, and (b) Sixty-five percent of the net income for the year from these properties.

Mining Exploration and Development Costs

Mining exploration and development costs that are expensed or amortized under IRC 291 are required to be computed under 10 year straight line amortization for minimum tax purposes.

Long Term Contracts

Taxable income from long term contracts entered into by the taxpayer on or after March 1,1986 must be determined under the percentage of completion method of accounting for computation of minimum tax.

Installment Sales of Dealer Property

In the case of dispositions of dealer property after March 1,1986, the installment method of accounting may not be used for minimum tax purposes.

Pollution Control Facilities

Taxpayers using the 60 month amortization rule on certified pollution control facilities are required to compute deprecation under the alternative depreciation system for minimum tax purposes.

Alternative Tax Net Operating Loss Deduction (ATNOL)

For taxable years after 1986 an alternative tax net operating loss deduction is allowed as a deduction for AMT. It is limited to 90 percent of the AMTI computed without regard to the ATNOL. Computation of the ATNOL is similar to the computation of the regular tax net operating loss. However adjustments required for AMT must be taken into account. The sum of the tax preferences reduces ATNOL except for the preference resulting from the charitable contribution of appreciated property. All passive losses are disallowed in computing ATNOL.

APPENDIX II

ITEMIZED DEDUCTIONS AND LOSSES ALLOWED FOR AMT PURPOSES

Certain losses that are deductible for the regular tax are not allowed in computing alternative minimum taxable income (AMTI). Also in computing AMTI only certain of the itemized deductions allowed for regular tax purposes may be deducted from adjusted gross income.

Passive Activity Losses

As a result of the TRA passive activity losses generally can only be deducted from passive activity losses. Any balance of losses must be carried forward and cannot be deducted from either portfolio income or earned income. This disallowance of losses is phased in over five years for regular tax purposes so that losses are not completely disallowed until 1991. Similar rules apply for AMT except that such losses are completely disallowed for AMT purposes. In addition a loss from a passive activity must be recomputed to reflect the AMT rules. Thus depreciation, intangible drilling and development costs, percentage depletion, installment sales and other adjustments and preferences must be reflected in computing the loss for AMT purposes.

Farm Losses From Tax Shelters

Individuals are not allowed to deduct losses from a tax shelter farm activity in computing AMTI. An individual's passive farm loss will be treated as a preference item to the extent that such treatment is not already denied for minimum tax purposes under any of the other preference provisions. The term "tax shelter farming activity" generally

means a farming syndicate or any other farming activity unless the taxpayer or a member of his family materially participated in the activity.

Itemized Deductions for AMTI

Itemized deductions for payment of any tax and miscellaneous itemized deductions are not allowed in computing AMTI.

Certain limits apply to itemized deductions for regular tax purposes. These also apply for AMT purposes and in addition there are further limitations.

Medical expenses are only deductible in excess of 10 percent of adjusted gross incomes compared to the excess over 7.5 percent for regular tax purposes.

Qualified housing interest is deductible for AMTI. Qualified housing interest is interest paid or accrued on indebtedness incurred after June 30,1982 in acquiring, constructing, or substantially rehabilitating property with is a principal residence or qualified dwelling. A principal residence is defined in IRC 1034. The impact is that interest on home second mortgages established after 1982 will not be deductible for AMT purposes unless the proceeds were used to improve the principal residence.

Investment interest expense is allowed as a deduction for AMTI to the extent of qualified adjusted net investment income. For regular purposes there is a phase in of the disallowance of the excess of investment interest over investment income. This excess is not allowed for AMT purposes.

Standard Deduction

Individuals may not deduct the standard deduction in computing the AMTI.

Personal Exemptions

Personal exemptions are not allowed as deductions in computing the AMTI.

FOOTNOTES

1. For a summary of the Tax Reform Act of 1986 see Explanation of Tax Reform Act of 1986, Commerce Clearing House, Chicago, 1986. The rules for the Alternative Minimum Tax are found in Internal Revenue Code Sections 56-59 inclusive.

2. The reader may substitute his or her favorite public charity in the examples given.

3. These examples are adapted from those in J. Pratt, J. Burns, and W. Kulsrud, Federal Taxation, Richard D. Irwin, Homewood, Illinois, 6th ed., 1988, pp. 11-32.

4. This section is based on material in Arthur Andersen et al., Tax Economics of Charitable Giving, Chicago, 10th ed., 1987.

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