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Residents May Face Federal Alternative Minimum Tax Problems

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Although the final state quarterly estimated income tax payment for 2003 is not due until January 15, 2004, people often plan to pay their State and local taxes in December, so as to be able to deduct these taxes in computing 2003 federal taxable income. However, there are very few one-size-fits-all rules in the world of taxation, and even this simple plan for accelerating federal tax deductions will not always be the best approach, once one takes into account the surprising and sometimes costly effects of the federal alternative minimum tax (or "AMT").¹ Especially in light of the federal, New York State and New York City tax rate changes that were enacted this year, it is critical that New York taxpayers examine their potential federal AMT taxpayer status, both to properly project this year's federal tax liability, and where possible to plan around the "hidden" costs of the AMT.

The AMT Plan

The concept that underlies the AMT is that taxpayers, in particular wealthy taxpayers, should not be allowed to take beneficial federal tax allowances to reduce their federal tax liability below a reasonable "minimum." The AMT recalculates federal taxable income without the benefit of certain deductions to produce a higher tax base known as alternative minimum taxable income, or "AMTI." AMTI is taxed at a rate lower than the "regular" tax rate. Taxpayers calculate the dollar amount

of tax they would under the regular tax, and the dollar amount of tax they would owe when the minimum tax rate is applied to their AMTI, and pay whichever tax produces the larger amount due.

The problems for New Yorkers arise because state and local income taxes deductions are not allowed in calculating federal AMTI. Consequently, as state and local personal income taxes increase, so does the risk that taxpayers will fall into the AMT. Currently, because the maximum New York State personal income tax rate is 7.7%, and the maximum rate under the City resident income tax is 4.45%, the tax base for measuring the AMT for New York City residents will automatically be up to 12.15% higher than their regular taxable income.

Moreover, as the federal AMT tax rates grow closer to the regular tax rates, it becomes more likely that the tax produced under the AMT will be higher than that produced under the regular tax. When the AMT was first introduced into the federal tax system, the highest marginal rate under the regular income tax was 70%, and the AMT was imposed at a rate of 10%. Today, for ordinary income (other than dividends), the highest federal rate of tax currently is 35%.² By contrast, the federal AMT rate for income other than capital gains is now 28%. Since the difference between the regular tax rate and the AMT rate is under ten points, the AMT is considerably more likely to occur.

For taxpayers whose income consists entirely of dividends or capital gains, the AMT has become a virtual certainty because there now is no difference between the regular tax rate and the AMT rate -- both are 15%.³ A taxpayer who has nothing but capital gains in 2003, will necessarily be subject to the AMT, and lose the benefit of federal deductions for such state and local income taxes paid in 2003.

Two simple examples serve to illustrate how the AMT can surprise New York taxpayers. Assume, for example, that an individual earns \$1 million of ordinary income in 2003. If he or she pays all of the \$121,500 state and local income tax due on that amount in 2003 the individual's regular taxable income would be \$878,500; the regular income tax liability would be \$316,699. The taxpayer's AMTI would be \$1,000,000, and the AMT, at 28%, would be \$280,000. In this example, the regular tax is higher, but the gap is not large. It is not difficult to posit that, when other types of income or expense are added to the mix, the lines will cross, and the taxpayer will fall into the AMT.

A taxpayer with \$1 million of capital gain also has state and local tax of \$121,500. However, the federal and AMT rates are essentially equal and the federal regular tax of 15.45% on \$10,000,000 less the \$121,500 state and local tax deductions will be lower than the AMT at 15% on \$1 million of income with no deductions. The New

York City resident with all capital gains (or dividend income) therefore must pay federal tax computed at 15%, without any deduction for state and local income taxes.

The Normal Pattern

In the more usual pattern of individuals earning a mixture of ordinary income and dividends/capital gain, the more income an individual earns in the federally-favored 15% category, the more likely that individual is to become an AMT taxpayer. Capital gains and dividends are taxed by New York at the same rate as other income, yet attract a lower federal tax rate for both the regular tax and the AMT -- 15%. With each additional dollar of capital gain, therefore, an individual adds 12.15 cents of tax preference items -- the New York personal income taxes paid -- while the regular tax of 15% of income less state tax deductions may well be less than the AMT at 15% of income without the state tax deductions.

Importantly, while the federal AMT was originally conceived as a way to bring wealthy taxpayers into the federal tax system, the changes that have been made to both the regular tax and the AMT over time, as well as the high rates of personal income tax now obtaining in New York and many other states, mean that the AMT has become a tax on much of the middle class. And while this is no secret in Washington, the reality is that the revenues drawn from imposing the AMT on middle-level taxpayers have become so large that it is now difficult for Congress to remedy the problem. This will likely be even more apparent once the effects of this year's marked federal rate cuts for dividends and capital gains work their way through individuals' tax returns.

If a federal solution is not in sight, what options remain for the individual who finds the AMT looming around the corner? The good news is that, at least in some situations, thoughtful planning may avert AMT problems. Of course, one option is to eliminate the high state and local tax costs altogether by changing one's residence and domicile to a

low tax jurisdiction. Properly implemented, this can be a legitimate and useful planning technique, particularly when the taxpayer is approaching an event, such as the sale of the family business or of an appreciated stock portfolio, and the change in domicile and residence will eliminate or reduce the state and local income tax imposed on such gains.

Decisions in New York

New York's case law is however replete with cases in which the changes made by an individual taxpayer were insufficient to break the ties to New York, and as a result New York could continue to impose its taxes on the taxpayer's income. Furthermore, where a taxpayer is contemplating establishing residence in a state that has some income tax, for example, Connecticut or New Jersey, one must be sensitive to the fact that an insufficient change in lifestyle and behavior patterns may land the hapless taxpayer in a situation in which both New York and the new home state seek to impose their income taxes, with no offsetting credits, on income earned from intangibles (e.g., capital gains and dividends). In addition, to the extent a taxpayer's income is derived from New York sources, either because the taxpayer works in New York or the taxpayer owns New York property, New York State income taxes will be imposed without regard to the taxpayer's state of residence. As a result, while leaving a high-tax jurisdiction may solve some AMT problems, it will not always be a useful or practical solution.

On a less dramatic plane, there are some timing techniques that may alleviate AMT pressures for certain taxpayers. For individuals who drift between the regular tax and the AMT depending on year-to-year changes in their income, it is useful to attempt to accelerate income into AMT years, where the top rate is only 28%, and to pay state and local taxes in non-AMT years, when the deduction will not be compromised. This may mean an individual will incur state and local penalties, for example, for underpaying quarterly estimates; or it may mean he or she loses

the use of funds by paying state and local income taxes sooner than otherwise due. Taking all of such factors into account, however, it may be useful to manage both income and expenses with a view to the year-to-year application of the AMT.

Another planning consideration can be meaningful to taxpayers who anticipate one year of disproportionately large income. A lawyer enjoying an unprecedented banner year, for example, should make sure he or she pays all of the New York income taxes due on that exceptional income in the year the income is earned. Paying only the quarterly estimated taxes based on the prior year's income will avoid incurring New York estimated tax penalties, but it can also mean that a large tax payment will come due in April of the following year. Depending on the numbers, the risk of being pushed into the AMT as a result of a disproportionately large April 15 tax payment can be very real. It is therefore important to recognize that situations in which the tax payments made in a year are not proportional to the income for that year can lead to computations in which the AMT rate on income calculated without state and local tax deductions is higher than the regular tax rate on income net of those deductions.

High Probability

Finally, as noted above, the advent of very favorable federal income tax rates for dividends and capital gains, coupled with this year's increases in the New York State and City personal income taxes, make it very likely that the AMT will apply to New Yorkers who have material amounts of dividend and capital gain income. With a 12.15% combined state and local tax rate, and a 15% regular income tax rate, there is very little room to operate within the regular tax before falling into the AMT. Moreover, the nature of these kinds of income, in particular of capital gains, makes it more likely there will be year-to-year differences in the tax regime applicable to any given individual taxpayer. Taken together, these factors make it especially important for individuals to examine their AMT posture,

and to consider the most effective timing of income and deductions. Examining one's portfolio also could be doubly useful, to ensure that sales of assets that generate capital losses occur in years with capital gains, so as to reduce the amount of net capital gain subject to federal, state and local income taxes.

State Legislation

On a related front, legislation enacted by the State in September, 2003⁴ has lightened the burden on partnerships and S corporations required to pay New York estimated taxes in respect of their nonresident and C corporation owners.⁵ However, the year should not close without two important reminders. First, nonresident partners in partnerships do-

ing business in New York should ascertain the amount of estimated taxes paid on their behalf on September 15, and possibly also June 15, 2003, and take such payments into account in calculating the fourth quarter New York estimated tax due. Payments made by the partnerships are to be credited to the partners' individual accounts; any overpayment of New York taxes can be claimed as a refund when the taxpayer files his or her 2003 individual New York income tax return.

Second, the next due date for estimated New York taxes, including those required to be paid by partnerships and S corporations, is January 15, 2004. The September legislation initiated a "waiver" system, under which law firms

and other partnerships will be absolved of the obligation to make estimated tax payments in respect of a partner if that partner certifies that he or she is in compliance with New York's filing requirements. To implement the statutory waiver system, the Department of Taxation & Finance has promulgated certification forms that partners can deliver to their partnerships, and which will absolve the partnership from estimated tax obligations for as many as three years. Copies of this new Form IT-2658-E are available on the Department's website.⁶

¹ The federal alternative minimum tax is set forth in Internal Revenue Code sections 55-59. This article focuses only on the application of the federal AMT to individuals.

² Federal disallowances of itemized deductions increase that rate somewhat, to an effective rate approximating 36%

³ The federal disallowance of itemized deductions has the effect of pushing the regular tax rate up a bit, but not materially.

⁴ Chapter 686, Laws of 2003 (S.5725), which amends Chapters 62 and 63 of the Laws of 2003 (S.1406-B/A.2106-B, and S.4968/A.8388, respectively).

⁵ Tax Law §658(c)(4).

⁶ The website address is <http://www.tax.state.ny.us>. The waiver form for corporate partners is Form CT-2658-E.

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