

Chapter 1: Individual Taxpayer Problems

Problem 1: Alternative Minimum Tax Update..... 1	Problem 4: Phaseouts and Limitations..... 30
Problem 2: Health Savings Account Update..... 15	Problem 5: Coal Royalty Payments..... 38
Problem 3: Investment Interest Expense 23	Problem 6: Limestone Royalty Payments 43

Please note. Corrections for all of the chapters are available at www.ace.uiuc.edu/taxschool. For clarification about acronyms used throughout this chapter, see the Acronym Glossary at the end of the Index.

PROBLEM 1: ALTERNATIVE MINIMUM TAX UPDATE

BACKGROUND INFORMATION

Preliminary Statistics for the 2005 Tax Year.¹ The chart below compares the impact of AMT on individual tax returns for the 2004 and 2005 tax years.

Tax Year	Number of Returns Reporting AMT Liability	Amount of AMT Reported
2004	3.133 million	\$12.06 billion
2005	4.045 million (29.1% increase)	15.87 billion (31.6% increase)

Of the total \$15.87 billion of AMT reported on 2005 tax returns, 96% (\$15.3 billion) was paid by taxpayers who reported 2005 AGIs of \$100,000 or more. However, as the following chart demonstrates, the lowest income taxpayers subject to AMT — those with 2005 AGIs under \$15,000 — reported the **highest average** AMT liability.

2005 AGI Range	Average Reported AMT Amount
Under \$15,000	\$16,920
\$15,000 to \$29,999	2,008
\$30,000 to \$49,999	1,523
\$50,000 to \$99,999	1,219
\$100,000 to \$199,999	1,807
\$200,000 or more	5,724

Estimated Statistics for the 2006 Tax Year. Before the preliminary statistics for 2005 individual tax returns were released in March of 2007, the most highly regarded AMT research predicted that “3.5 million taxpayers will be affected by the AMT in 2006.”²

However, since the preliminary IRS statistics for 2005 individual tax returns reported that 4 million taxpayers reported a 2005 AMT liability, the 3.5 million taxpayers estimate for 2006 tax returns may be low.

- If the rate of increase remained at 29.1% (see the first table above), a projected **5.2 million taxpayers would have reported an AMT liability on their 2006 returns.**
- If the rate of increase remained at 31.6% (see the first table above), it is projected that **individual taxpayers would have reported \$20.9 billion of AMT for 2006.**

¹ “Winter 2006–2007 Statistics of Income Bulletin,” IRS News Release IR-2007-55 (March 12, 2007)

² Greg Leiserson and Jeffrey Rohaly, “The Individual Alternative Minimum Tax: Historical Data and Projections,” updated November 10, 2006, www.taxpolicycenter.org/publications/template.cfm?PubID=9923

2007 Anticipated AMT Exemption Amounts

As of the date this book was printed, Congress had taken no action regarding the 2007 AMT exemption amounts. Based on the best information available, it is likely that legislation will be enacted to keep the 2007 AMT exemption amounts at 2006 levels. Therefore, the balance of Problem 1, AMT Update, uses that assumption. If the 2007 AMT exemption amounts differ from those allowed for 2006, see the “2008 What’s New Supplement” on the University of Illinois Tax School website (www.ace.uiuc.edu/TaxSchool) for revisions to Problem 1. This supplement will be available in January 2008.

The anticipated 2007 exemption and phaseout amounts are below. AMTI is alternative minimum taxable income, shown on line 28, Form 6251.

Anticipated 2007 AMT Exemption Amounts

Tax Year	Married Filing Jointly and Surviving Spouse	Single and Head of Household	Married Filing Separately
2007 (assumed)	\$62,550	\$42,500	\$31,275

Note. The minimum 2007 AMT exemption amount for a child under age 18 increased to \$6,300. The child may increase this AMT exemption by the amount of his earned income. See the Exemption Worksheet for line 29 in the 2007 Instructions for Form 6251 for more information.

Anticipated 2007 AMT Exemption AMTI Phaseout Ranges

Tax Year	Married Filing Jointly and Surviving Spouse	Single and Head of Household	Married Filing Separately
2007 (assumed)	\$150,000–400,200	\$112,500–282,500	\$75,000–200,100

It is expected that the anticipated 2007 legislation will extend current law by allowing most personal tax credits to be claimed against both regular tax and AMT liability. **If so, individual taxpayers will continue to receive the full benefit of the following 2007 personal tax credits:**

- Child and dependent care credit (Form 2441)
- Credit for the elderly or the disabled (Schedule R)
- Child tax credit (Form 8901, if required)
- Education credits (Form 8863)
- Adoption credit (Form 8839)
- Retirement savings contribution credit (Form 8880)
- Mortgage interest credit (Form 8396)
- Residential energy tax credit (Form 5695)

Note. The tax credit for new qualified hybrid vehicles was not allowed against 2006 AMT liability. Therefore, individual taxpayers impacted by AMT on their 2006 tax returns were denied part or all of their otherwise allowable hybrid vehicle tax credit. As of the date this book was printed, Congress had taken no action regarding an extension of the 2006 AMT rules to 2007 tax returns.

National Taxpayer Advocate Report.³ Nina Olson, the National Taxpayer Advocate, released her 2006 report to Congress in January 2007. In it, she designated the AMT for individuals and the federal tax gap as the most serious problems facing taxpayers. The executive summary of the AMT issue is shown below.

The National Taxpayer Advocate believes that the most serious problem facing taxpayers today is the complexity of the Internal Revenue Code, and the poster child for tax-law complexity is the Alternative Minimum Tax for individuals (AMT). . . . While the AMT was originally designed to prevent wealthy taxpayers from escaping tax liability through the use of tax-avoidance transactions, most of the significant tax loopholes that enabled taxpayers to escape tax at the time the AMT was written have long since been closed. Today, the AMT is left to punish taxpayers for engaging in such “classic tax-avoidance behavior” as having children or living in a high-tax state.

To be viewed as fair, a tax system must be transparent. Yet the complexity of the AMT is such that many, if not most, taxpayers who owe the AMT do not realize it until they prepare their returns. It adds insult to injury when many of these taxpayers discover that they also owe a penalty for failure to pay sufficient estimated tax because they did not factor in the AMT when they computed their withholding exemptions or estimated tax payments. Taxpayers subjected to this treatment may wonder whether their government has dealt fairly with them. To say the least, “gotcha” taxation is not good for taxpayers or the tax system. The National Taxpayer Advocate recommends that Congress repeal the provisions of the Internal Revenue Code that pertain to the Alternative Minimum Tax for individuals.

NEW MINIMUM TAX CREDIT RULES FOR 2007 RETURNS

Note. The **new rules** for 2007 returns apply to AMT credits carried forward from 2003 or earlier. The background information provided here is used later in the chapter to illustrate how the new rules apply to 2007 returns.

Background Information. One of the most costly inequities of AMT law prior to 2007 occurred when:

1. The taxpayer exercised an incentive stock option (ISO) and did not sell the stock in the year the ISO was exercised.
2. The shares acquired via the ISO exercise either lost value or became worthless in a later year.
3. The taxpayer paid significant AMT in the year of exercise on the “phantom income” AMT adjustment.
4. The taxpayer had to borrow money to pay the AMT liability in the year of the ISO exercise.

This unfortunate situation is explained in the following example.

Example 1. Jane exercised her employer’s ISO in March 2003. **This was not a cashless exercise.** Jane used her own funds for the \$10,000 grant price that she paid for the stock. **She did not sell the stock acquired by the ISO exercise in 2003 because she expected the stock to appreciate.** Following are the details relating to her 2003 exercise of the ISO:

Number of Titan Co. shares purchased	10,000
Exercise grant price per share (purchase price)	\$ 1
Market value price per share at the time of exercise	60
Untaxed (for regular tax) “bargain element” per share (\$60–\$1 purchase price)	59
Untaxed (for regular tax) total “bargain element” gain (10,000 shares × \$59)	590,000

Jane reported \$590,000 as an AMT adjustment on line 13 of her 2003 Form 6251. Her 2003 AMT was \$171,525. Jane’s 2003 Form 6251 is shown below. The \$590,000 AMT adjustment on line 13 is “phantom income,” not real income that can be spent. Jane was forced to borrow funds to pay her 2003 AMT liability of \$171,525.

³ IRS News Release IR-2007-04 (January 9, 2007)