

# National Conference of CPA Practitioners

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## Opening Comments

### **Blowing the Cover on the Stealth Tax: Exposing the Individual AMT Subcommittee on Taxation and IRS Oversight Senate Committee on Finance Hearing - May 23, 2005**

My name is Carol Markman. I am a Certified Public Accountant and have been in practice for over 25 years. I am currently a partner of Feldman, Meinberg & Co. LLP of Syosset, New York. I am the President of NCCPAP, the National Conference of CPA Practitioners, the only national professional organization representing only Certified Public Accountants in Public Practice. Our membership is by firm and all of the owners of member firms are Certified Public Accountants in public practice. The members of NCCPAP own and operate local and regional practice units ranging in size from sole proprietorships to organizations with many CPA partners and large professional staff. We represent practitioners all across the country that have clients in all 50 states. Most of the members of NCCPAP deal with the Internal Revenue Code on a daily basis in their work with taxpayers. We live the Internal Revenue Code every day and sort through its complexities constantly. We estimate that our members serve more than 500,000 businesses and individual clients in every state. We appreciate the invitation to participate in this hearing.

I have been asked to provide anecdotal information about how the Individual Alternative Minimum Tax ("AMT") affects our members' clients, the taxpayers of America. The AMT first became part of the Internal Revenue Code in 1969, after the then Treasury Secretary testified that there were 155 people with incomes over \$200,000 who had not paid any income taxes for 1967. In today's economy, this would be a person with income of \$1.1 million and paying no Federal Income Tax. The highest individual income tax rate in 1969 was 77 percent when Congress added a 10 percent AMT to the tax code. Until 2000, less than one percent of individual taxpayers were required to pay AMT tax in any given year. This was the situation even though the highest individual income tax rate had been reduced to 39.6 percent. For 2004, the highest individual Federal income tax rate was 33 percent and the highest AMT tax rate was 28 percent. It is estimated that 3.8 million taxpayers will be pay additional tax due to the AMT.

The NCCPAP Tax Committee collected redacted individual income tax returns from our members where the taxpayer was required to pay AMT. The returns we assembled do not constitute a statistically valid sample of AMT tax returns. They are just the returns we collected from our members. We have analyzed these returns to determine the reasons for the presence of AMT on the actual tax returns. The calculation requires two types of "adjustments": (1) "permanent adjustments", that is tax benefits that are lost

forever, so called such as state and local income taxes and (2) "tax preference items", which are mostly timing differences, such as post 1986 depreciation adjustments. The tax preference items are tax benefits that are *postponed* due to the AMT. These timing differences usually benefit the taxpayer in future years due to either basis adjustments or AMT Credits. The timing difference adjustments create a current cash flow problem for the taxpayer but they are the more fortunate victims of the AMT because they have the potential opportunity to recover the AMT tax paid at some point in the future.

The most common reasons our clients are subject to AMT are relatively large itemized deductions for state and local taxes, (state and local income tax or sales tax, real property tax, personal property tax) and miscellaneous itemized deductions. A colleague told me about a Federal income tax return of a single father with three children who earned \$70,483 at his job, had no other income and claimed the standard deduction. This taxpayer was required to pay \$100 in AMT on his 2002 income tax return. The trigger for the AMT was the exemptions he claimed for his three children. Surely this is not a taxpayer who should be subject to this additional tax. My colleague said he performed some modeling with this taxpayer's information and determined that the taxpayer would not be subject to AMT in 2004 on the same salary because of the increase in the AMT exemption included in the 2004 Tax Act, but this change in the AMT exemption is for 2004 only. As a result, a taxpayer with this fact pattern will again be subject to AMT in 2005, unless the law is changed. A taxpayer with wages of \$115,483 and the same fact pattern would be subject to \$174 of AMT for 2004. While these AMT tax amounts are small, the requirement that a taxpayer whose only income is wages needs to calculate his tax two ways is expensive, time consuming, wasteful and unfair. A taxpayer who is otherwise eligible to file a Form 1040EZ should not have to be concerned about the AMT.

One of the tax returns we received concerned a single, retired woman with no dependents. Her 2003 adjusted gross income of \$ 76,014 consisted of mostly Social Security, interest, dividends and net rental income. She paid \$2,697 of AMT, which was almost 30 percent of her Federal Tax liability because of her relatively large real estate taxes and her income from tax-exempt private activity bonds that were generated from a municipal trust. She was quite annoyed when told that she was subject to the AMT. She could not believe that she was in the target group for AMT.

Another return concerned a married couple with four children. Both spouses work outside the home earning a total of \$152,549 and they had less than \$1,000 in interest and dividends in 2004. Their state and local income and real estate taxes were \$16,820 and they had to pay \$937 in AMT. They have one child in college and one who will begin college next year. They are not like any of the 155 taxpayers who paid no

Federal income tax in 1969. The taxpayers indicated that they would have used the funds for the school expenses for their children.

Another one of our members recently told me about a letter he sent to a client explaining that she was subject to the AMT in part because of the interest income from the private activity bonds she held. She told the CPA that if he was a better tax preparer this would not have happened and he lost the client. We wonder if her **new** tax preparer properly reported the income from the private activity bonds.

One of the most difficult AMT add-backs to explain to clients is the one for employee business expenses. The Internal Revenue Code requires an employee, who incurs ordinary and necessary business expenses in the performance of his/her employment that are not reimbursed by his/her employer, to include those expenses with other miscellaneous itemized deductions. These expenses are required to be reduced by two percent of the taxpayer's adjusted gross income and can be further reduced by the phase out of itemized deductions. "Statutory Employees" and businesses in all forms, i.e., corporations, partnerships, LLC's, LLP's and sole proprietorships, are allowed to deduct all business expenses in full against gross income (subject to limitations such as 50% of meals). The only business expenses that are not allowed to be deducted in full are those incurred by employees. In addition, these expenses are an add-back for AMT tax calculation purposes. This can have a significant impact on some taxpayers. In another case another member told us of a single taxpayer with adjusted gross income of \$89,544 and \$20,018 of miscellaneous itemized deductions was subject to \$2,039 of AMT in 2004, 16 percent of his tax liability. Expenses related to the production of income are disallowed for AMT purposes on an individual tax return, but not on a business tax return.

The taxpayer also loses the tax benefit of the costs of producing income if the taxpayer receives an award for damages from a lawsuit and the attorney is paid the legal fees from the settlement. The taxpayer must include the full amount of the award in income but the legal fees are deductible as a miscellaneous itemized deduction subject to the phase-out and the 2 percent floor. The legal fees are an add-back in determining alternative minimum taxable income. It is, therefore, possible for the attorney fees and the tax liability to consume the majority of the damage award the taxpayer actually receives. One colleague described a case in which a lawsuit was settled for a payment of \$850,000. The taxpayer had incurred attorney fees of \$650,000. The full amount of the settlement was required to be reported by the taxpayer even though she received only \$200,000 for herself. Because of the AMT she has to report the entire \$850,000 as income with no deduction for the attorney fees and pay the AMT tax, which exceeded the \$200,000 she received.

The Civil Rights Tax Relief Act, which became law in October 2004, provides that, with respect to all prospective employment related and certain other settlements, only the amount payable to the client needs to be included in income so there is no AMT issue. The Code needs to be changed so that all legal settlements are reported net of legal fees.

Another colleague told me about a tax return where the taxpayer received a settlement because the stockbroker churned the taxpayer's accounts. The taxpayers, who suffered terrible capital losses, were able to offset the settlement against capital gains for regular tax purposes. However, the taxpayers, who are both retired, had no taxable income for the year of the settlement but were subject to \$19,222 in AMT because the legal fees were not an allowable deduction for AMT purposes.

Other miscellaneous itemized deductions that on tax returns we collected where the taxpayer was subject to the AMT are investment advisory fees, IRA fees and other investment related expenses, legal fees related to the production of income, the costs of tax return preparation and representation fees in connection with IRS audits.

Another one of our members described a situation involving a 2002 tax return for a widow who had inherited a group of securities that were not appropriate for her circumstances. She wanted to rearrange the portfolio but was concerned about the capital gains tax since there were significant unrealized capital gains. She was told about the possible consequences of the AMT, where a taxpayer has significant capital gain income. The CPA prepared tax projections for her in order to determine the maximum amount of long-term capital gain income that the taxpayer would be able to have and not be subject to the AMT. Although the current AMT calculations have nothing to do with capital gains, increasing capital gain income subjects the taxpayer to AMT because of the phase-out of the AMT exemption.

I was unable to locate actual tax forms for 1969. However, I found some tax returns from 1979. The form used to calculate the AMT in 1979 and the related instructions were each one page long. The taxpayer was permitted to reduce Adjusted Gross Income by a varying amount (\$1,700 to \$3,400) based on filing status and by \$1,000 per dependent. There were two lines for tax preference items, adjusted itemized deductions and capital gain deductions. The 1979 adjustments to itemized deductions did not include miscellaneous itemized deductions or private activity bond income. Also itemized deductions were not subject to phase-out for regular tax purposes. There was an add-back for the capital gains deduction that was excluded for regular taxes. The exemption amount for individuals was \$20,000 except if married filing separately. The AMT tax rate varied from 10 to 25 percent and the highest marginal income tax rate for regular tax was 70 percent.

By comparison, the form used to calculate the AMT in 2004 consists of two full pages and the related instructions are eight pages long. There are 26 lines of adjustments, no amount based on filing status and no amount per dependent. The exemption amount for individuals was \$40,250 for single, \$58,000 for married filing jointly and \$29,000 for married filing separately. The AMT tax rate varied from 25 to 28 percent and the highest marginal tax rate for regular tax was 35 percent.

The AMT has been called the “acutely messy tax” and is a perfect example of the tax law giving with one hand and taking away with the other. The regular tax rates have been lowered significantly but the AMT rates have not changed and the exemption amounts have not been indexed for inflation. If nothing is done to change the Tax Code, more than one third of American taxpayers will be subject to AMT by 2010. Although NCCPAP’s position is that the AMT should be repealed, there may, in fact, be a place for the AMT in the tax code. The AMT certainly should not affect those taxpayers with moderate income, a few children and real estate taxes on their principal residence, wherever they may live.

Thank you very much for this opportunity. NCCPAP stands ready to supply you with any additional anecdotal information you may need.

Respectfully submitted,

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on behalf of the National Conference of CPA Practitioners