Internal Revenue Service
Market Segment Specialization Program

Alternative Minimum Tax For Individuals

Audit Technique Guide (ATG)

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The taxpayer names and addresses shown in this publication are hypothetical. They were chosen at random from a list of names of American colleges and universities as shown in *Webster's Dictionary* or from a list of names of counties in the United States as listed in the *U.S. Government Printing Office Style Manual*.

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Alternative Minimum Tax for Individuals
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Chapter 1

Introduction

A Brief History of Alternative Minimum Tax

Taxpayers who are not required to pay tax under the regular tax system may still be liable for tax under the Alternative Minimum Tax (AMT) laws. These laws create an equity in the system, requiring higher income individuals with certain deductions to pay tax. Without the AMT laws, these individuals would pay little or no tax while those with lower income levels and no deductions would pay higher tax.

The AMT laws began in 1969. Since that time, the laws surrounding the computation of the tax have been modified through various tax revision acts. The 1969 law subjected individuals to an add-on tax at a 10-percent rate in addition to their regular tax. The Tax Revision Act (TRA) of 1976 increased the rate from 10 to 15 percent and decreased the exemption amount.

The Revenue Act of 1978 introduced the first Alternative Minimum Tax. The taxpayer was liable for AMT only when the tentative AMT exceeded the sum of regular tax and any add-on minimum tax. In 1982, the AMT system was substantially overhauled. The new AMT enacted was calculated at a 20-percent rate less an exemption based on the taxpayer's filing status. Similar to current law, AMT was due only to the extent that it exceeded an individual's regular tax.

The last significant overhaul to the AMT system was the Tax Reform Act (TRA) of 1986, effective for 1987 and subsequent tax years. The law was changed to consider the deferral effect of AMT items over a long-term period, such as depreciation and amortization adjustments. For the first time, such deferral items could result in positive AMT adjustments in the initial years of a property's life and corresponding negative adjustments in subsequent years when the effect of the earlier years' accelerated depreciation reversed. A significant revision of the TRA of 1986 is the concept that AMT is now a separate, but parallel, tax system from the one used to compute an individual's regular tax. Accordingly, an individual taxpayer is required to maintain separate records for regular tax and AMT purposes.

Subsequent legislation, the Revenue Act of 1987, the Technical and Miscellaneous Revenue Act of 1988 (TAMRA), the Revenue Reconciliation Acts of 1989, 1990, and 1993, and the Energy Act of 1992, made further modifications and clarifications to the AMT rules of the TRA of 1986.

In the Taxpayer Relief Act of 1997, IRC section 55(b)(3) was added to adjust the AMT for capital gains. In 1998, that section was revised to recognize the new capital gain rates.

Current Years' AMT

Internal Revenue Code sections 55, 56, 57, 58, and 59 contain the current laws (1993 to 1998) surrounding this computation. Prior years' laws (prior to 1993) will be discussed separately later in the guide.

AMT is calculated by adjusting the taxpayer's regular taxable income with a number of tax preference items and adjustments. Tax preference items are positive items increasing Alternative Minimum Taxable Income (AMTI) and are excluded from regular taxable income. Tax preference items include tax-exempt interest from certain private activity bonds, depletion, intangible drilling costs, accelerated depreciation on leased personal or real property placed in service before 1987, amortization of certain pollution control costs or facilities placed in service before 1987, and certain leased property subject to accelerated cost recovery.

Adjustments for AMT may result in positive and negative amounts and may have implications in subsequent tax years. Adjustments include standard or itemized deductions, personal exemptions, 1987 and subsequent-year depreciation based on the alternative depreciation system, amortization of circulation and research and experimental costs, amortization of mining exploration and development costs, amortization of pollution control costs for facilities placed in service after 1986, use of percentage completion for long-term contracts entered into after February 28, 1986, installment sale adjustments, gain or loss adjustments on the disposition of business property, incentive stock options, tax shelter farm loss limitations, passive activity loss limitation, and AMT net operating loss.

Chapter 2
Computing AMT

Form 6251 Alternative Minimum Tax-Individuals

AMT is computed using Form 6251. This form must be attached to the income tax return. Form 6251 has three parts. Part I identifies and computes the total adjustments and preference items. Part II computes the AMTI. This computation requires the consideration of prior and current year net operating losses (NOLs). Part III identifies the taxpayer's exemption amount and computes the AMT owed by the taxpayer. Each of these areas are addressed later in the material.

The applicability of AMT must be made on a return to return basis. If the return contains a Form 6251, the form should be analyzed to determine if the tax was properly computed. If not, a determination should be made as to whether AMT would apply. Upon completion of each audit, a determination should be made as to whether or not the AMT applies and, if so, the amount of AMT owed by the taxpayer.

To help you understand the computation of AMT, this guide will follow Form 6251 line by line. Copies can be obtained from the IRS Digital Daily on the Internet at www.irs.gov.

Adjustments and Preference Items

To arrive at Alternative Minimum Taxable Income (AMTI), certain adjustments must be made to "regular" taxable income. When computing AMTI for 1991 and subsequent tax years, we will begin with taxable income before exemptions and add or subtract all the applicable adjustments and tax preference items. Part I of Form 6251 lists the adjustment and preference items. Part II of Form 6251 asks for taxable income before exemptions from the tax return. (For example, see line 37 of the 1998 Form 1040, *U.S. Individual Income Tax Return*.)

Line 1, Standard Deduction and Itemized Deductions

Line 1 applies only if the taxpayer took the Standard Deduction. If the taxpayer itemized deductions, leave Line 1 blank and go to Line 2.

A taxpayer will either itemize deductions on Schedule A, Itemized Deductions, or use the standard deduction when computing his or her taxable income. The amount of the taxpayer's deduction is listed on Form 1040 as follows:

Tax Year(s)	Line Number on Form 1040
1993-1996	34
1997	35
1998	36

If the taxpayer claims the Standard Deduction per IRC section 63(c), this amount will not be allowed when computing the Alternative Minimum Taxable Income. IRC section 56(b)(1)(E) lists this amount as an adjustment for purposes of AMT.

IRC section 56(b)(1)(E) also disallows the personal exemptions under IRC section 151 for AMT purposes.

Mechanically, this disallowance is done differently on Form 6251 for years prior to 1991 than it is done for years 1991-1998. For years prior to 1991, Form 6251 used Taxable Income from Form 1040. Thus, Form 6251 required adding back the personal exemptions (as well as certain itemized deductions or the standard deduction). By contrast, for years 1991 to 1998, Form 6251 uses Taxable Income Before Exemptions. Thus, for years 1991 to 1998, Form 6251 does not require adding back the personal exemptions (though it still requires adding back certain itemized deductions or the standard deduction).

IRC section 152(d)(3) provides a phase-out of personal exemptions when Adjusted Gross Income (AGI) exceeds an assigned threshold amount, adjusted for inflation. For years in which personal exemptions need to be added back on Form 6251 (that is, years prior to 1991), only the amount of personal exemptions actually taken on Form 1040 should be added back on Form 6251. Thus, if, due to the phase-out, the taxpayer's personal exemptions were limited, only that limited amount should be added back as an adjustment on Form 6251.

EXAMPLE 1: Joe and Jan's 1994 income tax return shows AGI of $60,000. They were not able to itemize their deductions so they claimed the standard deduction amount of $6,350 for the married filing jointly status. In addition, they had personal exemptions of $4,900. Their taxable income was $48,750. To compute Joe and Jan's AMTI, you must start with their taxable income before exemptions of $53,650 and add back their standard deduction amount of $6,350 arriving at an AMTI of $60,000.

Audit Techniques

1. If the taxpayer has not prepared Form 6251, prepare one to include the taxpayer's standard deduction and/or itemized deductions as an adjustment.

2. If the taxpayer has prepared Form 6251, verify that the correct figures have been used on Form 6251 for personal exemptions and standard deduction.

3. If changes are made during the audit to personal exemptions, itemized deductions, or standard deductions, make changes to line 1 and/or line 16 of Form 6251.

Line 2, Medical and Dental Expenses

Line 2 applies only if the taxpayer itemized deductions. If the taxpayer took the Standard Deduction, Line 2 should be blank.

For regular income tax purposes, medical and dental expenses are deductible to the extent they exceed 7.5 percent of AGI. For AMT purposes, medical and dental expenses are allowable only to the extent they exceed 10 percent of AGI.

On line 2 of Form 6251, the taxpayer enters the smaller of Schedule A, line 4 or 2.5 percent of Form 1040, line 32, which allows the taxpayer medical and dental expenses that exceed 10 percent of AGI. Note that the 1993 Form 6251 contains a worksheet on page 2.

The following example illustrates this point.

EXAMPLE 2: Patrick has $13,000 in medical expenses. His AGI is $100,000. His medical expense for regular tax purposes is $5,500 ($13,000-(7.5 percent x $100,000)). This amount would be reflected on line 4 of Schedule A. His medical expense for AMT purposes would be $3,000 ($13,000 - (10 percent x $100,000)). Medical expense has been deducted on the tax return in the amount of $5,500; therefore, medical expenses of $2,500 must be added back to arrive at the allowable AMT medical expenses of $3,000 ($5,500-$2,500).

You arrive at the same $2,500 adjusted by using the directions on line 2 of Form 6251, and entering the lesser of the amount on line 4 of Schedule A ($5,500) or 2.5 percent of line 32 ($2,500) (2.5 percent x $100,000).

There had been some confusion as to whether AGI for regular income tax purposes should be used or if AGI should be recomputed for AMT purposes and the recomputed AMT AGI be used. In late 1994, IRS issued Treas. Reg. section 1.55-1, effective for taxable years beginning after December 31, 1993. Treas. Reg. section 1.55-1(b) states "In determining the alternative minimum taxable income of a taxpayer other than a corporation, all references to the taxpayer's adjusted gross income or modified adjusted gross income in determining the amount of items of income, exclusion, or deduction must be treated as references to the taxpayer's adjusted gross income or modified adjusted gross income as determined for regular tax purposes."

Therefore, for tax years beginning after 1993, in all computations requiring an AGI limitation, for a taxpayer other than a corporation, the AGI for regular tax purposes must be used.

Audit Techniques

1. If no Form 6251 has been prepared, include any medical expenses not allowed for AMT purposes.

2. If Form 6251 has been prepared, verify that an adjustment has been made for the difference between 7.5 percent for regular tax purposes and ten percent for AMT purposes.

3. Any adjustments affecting AGI will affect the amount of medical deductions allowable for regular and AMT purposes. If changes are made to AGI, make corresponding changes to medical adjustments.

4. If adjustments are made to itemized deductions, corresponding changes should be made to Form 6251.

Line 3, Taxes

Line 3 applies only if the taxpayer itemized deductions. If the taxpayer took the Standard Deduction, Line 3 should be blank.

For AMT purposes, no deductions are allowed for state, local, and foreign real property; taxes; state and local personal property taxes; state, local and foreign income taxes; war profits and excess profits taxes. If any of these deductions are taken on Schedule A for regular tax purposes, they must be added back when computing AMT. Any items deducted in arriving at AGI are not adjusted for AMT purposes. Thus, any real estate taxes deducted on Schedules C (Profit or Loss From Business), F (Profit or Loss From Farming), or E (Supplemental Income and Loss).

EXAMPLE 3: Josh claims state and local income taxes of $2,500 and real estate taxes of $4,250 on his Schedule A for 1994. His taxable income before personal exemptions is $34,000. Excluding all other items, his AMTI will be $40,750 ($34,000 + $2,500 + $4,250).

Audit Techniques

1. If no Form 6251 was prepared, prepare one including any unallowable taxes as an adjustment.

2. If Form 6251 was prepared, verify that the correct tax figure has been used for AMT purposes.

3. Verify that taxes paid were due and owing. Some taxpayers may attempt to shift tax payments and deductions from AMT to regular tax years when no AMT liability exists.

Line 4, Interest on Home Mortgage

Line 4 applies only if the taxpayer itemized deductions. If the taxpayer took the Standard Deduction, Line 4 should be blank.

This pertains to interest on a home mortgage not used to buy, build, or improve a home. The AMTI mortgage interest deduction is allowed in a similar manner to the regular mortgage interest deduction with one modification. Mortgage interest is allowed for AMTI purposes only if it is used to acquire, construct or improve the property. Property includes the taxpayer's qualified residence (defined in IRC section 121) and second home (defined in IRC section 163(h)(4)(A)(i)(II)). The only mortgage interest not allowed for AMTI purposes would be any home equity indebtedness taken out by the taxpayer which is not used to improve the property.

EXAMPLE 4: Jim and Donna deduct $12,000 of home mortgage interest on their Schedule A for tax year 1994. Of this $12,000, $10,000 is from the original mortgage used to acquire the home in 1992. The remaining $2,000 is from a home equity loan. The home equity loan was taken out in 1993 for $22,000 and was used to add a bathroom and deck to the home. For AMTI purposes, no adjustment would need to be made because the home equity loan was used to improve the home.

EXAMPLE 5: Assume the same facts except that the home equity loan was used to purchase a new family car. Jim and Donna would have to add back the $2,000 interest from the home equity loan because the proceeds were not used to improve the residence. The $2,000 is allowed for regular tax purposes, assuming it meets the regular home mortgage interest rules of IRC section 163(h)(3)(C).

Audit Technique

Home equity loans should be verified to determine what the proceeds of the loan were used for. If home improvements were made, request documentation of the improvements. Any interest on loans or portion of home equity loans not used for home improvements should be added back on line 4 of Form 6251 when computing AMT income.

Line 5, Miscellaneous Itemized Deductions

Line 5 applies only if the taxpayer itemized deductions. If the taxpayer took the Standard Deduction, Line 5 should be blank.

No miscellaneous itemized deductions are allowed for AMT purposes. IRC section 56(b)(1)(A) (i). For regular tax purposes, taxpayers are allowed miscellaneous deductions in excess of two percent of their adjusted gross income.

EXAMPLE 6: Jeff and Mary have adjusted gross income of $30,000 for 1994. They have claimed $3,000 in miscellaneous deductions for 1994. For regular tax purposes, Jeff and Mary will have a deduction for miscellaneous items in the amount of $2,400 ($3,000-($30,000 x 2 percent)). For AMT purposes, no deduction is allowed. Therefore, the $2,400 will have to be added back on line 5 of Form 6251 to compute AMTI and AMT.

Audit Techniques

1. If no Form 6251 was prepared, prepare one disallowing any miscellaneous deductions allowed as deductions on Schedule A.
2. If a Form 6251 was prepared, verify that the amount of miscellaneous deductions deducted is included as an addition to income for AMT purposes.
3. If any audit adjustments are made which affect AGI, corresponding adjustments must be made for miscellaneous deductions for regular and AMT purposes.
4. If any audit adjustments are made that affect miscellaneous itemized deductions, corresponding adjustments must be made on Schedule A and Form 6251.

Line 6, Refund of Taxes

Since for AMT purposes no deduction is allowed for state, local, and foreign income taxes; state and local personal property taxes; and state, local, or foreign real property taxes, any refund of these amounts does not have to be included in income when arriving at AMTI. IRC section (56)(b)(1)(D). If previously included for regular tax purposes, this amount will be a negative adjustment when computing AMTI. However, these are only for amounts deducted on Schedule A. Thus, if the amounts are deducted in arriving at AGI (that is,. deducted on Schedules C, E, or F) the amounts will be includible for AMT purposes.

EXAMPLE 7: Jill included in her 1994 income for regular tax purposes a state income tax refund of $300. In the previous tax year, she itemized her deductions, including a deduction for all state taxes paid. Her taxable income before personal exemptions is $30,000. Excluding all other adjustments her AMTI will be $29,700.

Audit Techniques

1. If the taxpayer has included an amount on line 6 of Form 6251, verify that the taxpayer received a tax benefit from the amount of the tax refund.

2. If the taxpayer has not prepared Form 6251 and has received a tax refund for which a tax benefit was received, include the amount of the refund as a negative adjustment on Form 6251.

Line 7, Investment Interest

Line 7 applies only if the taxpayer itemized deductions. If the taxpayer took the Standard Deduction, Line 7 should be blank.

For regular tax purposes, investment interest is allowed up to the amount of investment income generated for the tax year. IRC section 163(d)(1). Investment interest is modified for AMT purposes to include interest on any specified activity bond and any deduction referred to in IRC section 57(a)(5)(A). Therefore, any interest from these bonds is includible in income, and interest expense incurred in connection with these bonds is allowed as a deduction for AMT purposes. The interest from these bonds is included on line 13 of Form 6251. See the rules for line 13.

In addition, all adjustments contained in IRC sections 56, 57, and 58 apply when arriving at net investment income per IRC section 163(d) for AMT purposes.

EXAMPLE 8: For 1994, Jed has Investment Income of $25,000 reported on the return. He has also claimed investment interest expense of $9,000 on Schedule A. During 1994, he earned interest of $5,000 from a specified activity bond. In connection with this bond, he has investment interest expense of $1,000. Excluding all other AMT adjustments, if Jed's 1994 taxable income before personal exemptions is $115,000, his AMTI will be $119,000 ($115,000 + $5,000 - $1,000).

Audit Techniques

1. Ask the taxpayer whether he or she has any interest from specified activity bonds. Taxpayers are required to include tax-exempt interest on line 8b of Form 1040. The taxpayer should be questioned in depth about the type of tax-exempt interest.
2. The taxpayer must recompute investment income allowing for adjustments and tax preference items per IRC sections 56, 57, and 58.
3. Any interest expense incurred in relation to specified bond interest will be allowed as an AMT deduction up to the amount of the specified bond interest.

Line 8, Post-1986 Depreciation

Line 8 applies if the taxpayer claimed depreciation on Schedule C or Schedule C-EZ (Net Profit From Business). If the taxpayer did not have depreciation deductions, Line 8 should be blank.

The Tax Reform Act of 1986 modified the previous Accelerated Cost Recovery System (ACRS). The name for the current depreciation system is Modified Accelerated Cost Recovery System (MACRS). Under this system, personal property placed in service after 1986 is grouped into eight recovery classes of property. The property is placed in these classes based on the Asset Depreciation Range (ADR) guidelines. These guidelines are stated in Rev. Proc. 87-56.

1. *3-Year Class* - Property with an ADR life of 4 years or less and certain race horses. IRC sections 168(e)(1), (e)(3)(A)(i). Automobiles are not included in this class even though they have a 4-year ADR life.

2. *5-Year Class* - Property with an ADR life of more than 4 years, but less than 10 years. IRC section 168 (e)(1). This includes automobiles, light trucks, computers and peripheral equipment, office machinery, property used in research and experimentation and breeding and dairy cattle. IRC section 168 (e)(3)(B).

3. *7-Year Class* - Property with an ADR life of at least 10 years but less than 16 years. IRC section 168 (e)(1). It includes office furniture and fixtures.

4. *10-Year Class* - Property with an ADR life of at least 16 years, but less than 20 years. IRC section 168(e)(1). This includes water transportation equipment and single purpose agriculture and horticultural structures. IRC section 168(e)(3)(D)(i).

5. *15-Year Class* - Property with ADR life of at least 20 years, but less than 25 years. IRC section 168(e)(1). It includes certain depreciable improvements made directly to or added to land such as fences, roads, bridges, and shrubbery.

6. *20-year Class* - Property with an ADR life of at least 25 years. IRC section 168(e)(1). It includes farm buildings and municipal sewage treatment plants.

7. *Nonresidential Real Property* - This is IRC section 1250 property that is not Residential Rental Property or property with an ADR life of less than 27.5 years. IRC section 168(e)(2)(B). The recovery period is 31.5 years for property placed in service before May 13, 1993, or 39 years for property placed in service after May 12, 1993.

8. *Residential Rental Property* - This includes real property such as rental homes or structure if eighty percent or more of its gross rental income for the tax year is from dwelling units. IRC section 168(e)(2)(i). The ADR life for this property is 27.5 years.

Under MACRS, depreciation can be computed one of five ways. But first, two terms need to be identified. They are General Depreciation System (GDS) and Alternative Depreciation System (ADS). GDS uses the life per the eight main property classes. ADS uses the specific assigned class life per Rev. Proc. 87-56.

The five methods for computing depreciation under MACRS are:

1. 200-percent declining balance method over the GDS recovery period. This method switches to straight line in the year that it provides a greater deduction.

2. 150-percent declining balance method over the GDS recovery period. This method also switches to straight line when it provides a greater deduction.

3. Straight line (SL) using the GDS recovery period.

4. 150-percent declining balance over the ADS recovery periods, switching to straight line when that method provides a greater deduction

5. Straight line using the ADS recovery period.

The declining balance methods provide greater deductions in the first years of service with lesser amounts at the end of the asset's life. By contrast, straight line provides equal deductions over the life of the asset. In addition, the GDS methods provide shorter periods for depreciation than do the ADS methods. Also, there are certain restrictions on which types of property can use which of the above methods.

While a method is prescribed for each type of property, the taxpayer may elect to use an alternative method. The following chart summarizes the prescribed method and the alternative method available for each type of property.

Recovery Class	Prescribed Methods	Alternative Methods
3-Year Class	200 % DB-GDS	150 % DB-ADS
5-Year Class	200 % DB-GDS	SL-GDS
7-Year Class	200 % DB-GDS	SL-ADS
10-Year Class (Non-Farm)	200 % DB-GDS	
3-year Class	150 % DB-GDS	DB-ADS
5-Year Class	150 % DB-GDS	SL-GDS
7-Year Class	150 % DB-GDS	SL-ADS
10-Year Class (Farm)	150 % DB-GDS	
15-Year Class	150 % DB-GDS	SL-ADS
20-Year Class (Nonfarm and Farm)	150 % DB-GDS	SL-GDS
Nonresidential and Residential Property	SL-GDS	SL-ADS

For purposes of AMT, the taxpayer must use the 150-percent declining balance method with a half-year convention using the asset's ADR class life. IRC section 56(a)(1)(A). For real property, the taxpayer must use straight line using the ADR class life. IRC section 56(a)(1)(A). The ADR class life for all real property is 40 years. IRC section 168(g)(2)(c)(iii).

If the taxpayer elects the ADR method for regular tax purposes, no adjustment would have to be made for AMT purposes. However, most taxpayers will use the accelerated methods which provide for maximum deductions in the assets' early years. Therefore, an adjustment will have to be made for AMT purposes. The adjustment will be the difference between the amount of depreciation claimed by the taxpayer and the amount of depreciation per the AMT SL-ADS method.

IRC section 356(a)(1)(A)(i) changes for property placed in service after December 31, 1998.

Taxpayers have to keep two depreciation tables. One for regular tax purposes and one for AMT purposes. These tables will also be necessary to compute the gain or loss if the asset is disposed of during the taxable year.

Use the tables in Rev. Proc. 87-57 to determine the applicable depreciation for each year in question. There are tables for depreciation for regular tax purposes and for AMT purposes.

For property placed in service after December 31, 1998, the taxpayer may elect to use AMT depreciation for regular tax purposes.

EXAMPLE 9: Samantha is an independent court reporter. She purchases and places into service a new word processor on June 6, 1994, costing $6,500.

For regular tax purposes, depreciation was computed as follows:
200-percent Declining Balance -- 5-Year Property

Year	Basis	Percentage	Depreciation
1	$6,500	20%	$1,300
2	$6,500	32%	$2,080
3	$6,500	19.2%	$1,248
4	$6,500	11.52%	$ 749
5	$6,500	11.52%	$ 749
6	$6,500	5.76%	$ 374

For AMT purposes, depreciation is computed as follows:

Year	Basis	Percentage	Depreciation
1	$6,500	15 %	$ 975
2	$6,500	25.5 %	$1,658
3	$6,500	17.85 %t	$1,160
4	$6,500	16.66 %	$1,083
5	$6,500	16.66 %t	$1,083
6	$6,500	8.33 %	$ 541

Comparison of Depreciation, regular versus AMT:

Year	Regular	AMT	AMT Adjustment
1	$1,300	$ 975	$ 325
2	$2,080	$1,658	$ 422
3	$1,248	$1,160	$ 88
4	$ 749	$1,083	($ 334)
5	$ 749	$1,083	($ 334)
6	$ 374	$ 541	($ 167)

Therefore, years 1, 2, and 3 will require a positive adjustment of $325, $422, and $88, respectively. Years 4, 5, and 6 will result in negative adjustments of ($334), ($334), and ($167), respectively.

If the taxpayer is allowed a deduction under IRC section 179, Election to Expense Depreciable Property, no AMT adjustment is required. Examiners should be aware that if the IRC section 179 deduction is disallowed and regular depreciation is taken, this could affect AMT.

Leasing property does not affect the AMT calculation. Lease payments are fully deductible for both regular and AMT purposes.

In addition to the rules discussed above, listed below are some items peculiar to specific industries.

1. Per IRC sections 168(e)(3)(D)(i) and 168(g)(3)(B), single purpose agricultural and horticultural structures are depreciated over a 10 year period for MACRS and over 15 years for AMT.

2. Depreciable farming property placed in service after 1988 must be depreciated under MACRS using the 150-percent declining balance method. IRC section 168(b)(2)(B).

3. No AMT adjustment is required for property depreciated on the units-of-production or machine hours run method.

Audit Technique

If depreciation is shown on the tax return, ask the taxpayer for a detailed depreciation schedule for regular and AMT purposes. If the taxpayer is claiming a depreciation deduction and no adjustment item is listed for AMT, there is a high probability that there should be an adjustment on Form 6251 for AMT. Depreciation on the schedule should be verified to insure that the taxpayer is using the correct method for both regular and AMT purposes.

Line 9, Adjusted Gain or Loss

As mentioned in the depreciation section, the taxpayer must use a specific method for computing the gain or loss on disposition of property when computing AMT. Unless the taxpayer also uses this method for regular tax purposes, an adjustment is generated for AMT purposes. The taxpayer must also maintain a record of AMT basis. If the taxpayer disposes of a piece of property in a tax year, the AMT gain must be computed using the sales price and the basis as adjusted for AMT depreciation. The difference between this gain and the gain computed for regular tax purposes will be an adjustment for purposes of AMT.

EXAMPLE 10: Assume in Example 9 that Samantha sold the word processor during the third year of use for $5,950.

Gain for Regular Tax Purposes

Sales Price		$5,950
Less: Adjusted Basis		
Basis	$6,500	
Less:	($4,004)	($2,496)

Gain on Sale		$3,454
		======

Gain for AMT Purposes

Sales Price		$5,950
Less: Adjusted Basis		
Basis	$ 6,500	
Less:	($3,213)	($3,287)

Gain on Sale		$2,663
		======

In this example you would have a negative adjustment to AGI of $791.

Audit Technique

As discussed previously, the AMT rules require the taxpayer to use 150-percent declining balance or straight-line depreciation instead of the more accelerated methods. Thus, the basis for AMT purposes and regular purposes will differ. Any sale of assets during the year should be verified for AMT basis versus regular tax basis.

Line 10, Incentive Stock Options

IRC section 421 contains the rules for taxing stock transferred pursuant to the exercise of employee incentive stock options (ISO). For regular tax purposes, these rules allow the employee to defer (and possibly avoid) recognizing the income attributable to the difference between the option's exercise price and the stock's fair market value (FMV) on the date of exercise (the spread). For the stock to receive this treatment, IRC section 422(a) requires that it cannot be disposed of within 2 years from the date the option is granted or within 1 year after the option is exercised. If the stock is disposed of after the holding periods expire, the excess (if any) of the amount realized over the employee's basis in the stock is long-term capital gain. If the stock is disposed of before the holding periods expire, the employee recognizes compensation income, in the year of sale, equal to the lesser of the spread at exercise or the spread between the employee's basis and the amount realized on the sale. IRC section 421(b).

IRC section 422(b) defines an ISO to be "an option granted to an employee for any reason connected with his employment by a corporation, if granted by the employer corporation or its parent or subsidiary corporation to purchase stock of any such corporations." To qualify as an ISO, IRC section 422(b) requires that the option be granted under an adopted plan that is approved by the corporation's shareholders; that the option be granted within 10 years after the earlier of the dates when the plan was adopted or approved; that the option cannot be exercisable beyond 10 years after the date of grant; that the exercise price be not less than the fair market value of the stock on the date that the option is granted; that the option be exercisable during the employee's lifetime only by the employee and not be transferable other than by will or the laws of descent and distribution; and that, when the option is granted, the employee cannot own more than 10 percent of the total combined voting stock of any corporation in the controlled group. However, otherwise conforming options granted to more than 10 percent of the shareholders will qualify as ISO if the option's exercise price is at least 110 percent of the stock's fair market value (FMV) on the date of grant and the option is exercisable for only 5 years. IRC section 422(c)(5).

EXAMPLE 11: CLC Corporation grants Jean an Incentive Stock Option on February 10, 1992, to buy 3,000 shares of CLC Corporation stock at $10 per share ($10 is also the fair market value on this day). On July 1, 1993, Jean exercises her option, when CLC's stock's fair market value is $21 a share and CLC transfers 3,000 substantially vested shares at $10 per share. On November 3, 1994, Jean sells all her stock at $30 per share. For regular tax purposes, Jean has a long-term capital gain of $60,000 on the sale ($90,000 selling price less $30,000 purchase).

IRC section 56(b)(3) states that IRC section 421 will not apply for AMT purposes. Since IRC section 421 will not apply, the rules of IRC section 83 dealing with property transferred in connection with performance of services will apply. This section requires the recognition of the excess of the stock's FMV over the stock's exercise price when the stock is substantially vested. See Treas. Reg. Section 1.83-3(b). An AMT adjustment is required only when the FMV of the stock exceeds its exercise price.

EXAMPLE 12: Assume the same facts as in Example 11. For regular tax purposes, Jean will not recognize any taxable income on July 1, 1993, the day of exercise. However for AMT purposes, Jean will recognize income of $33,000 ($63,000 FMV price less price paid of $30,000) on July 1, 1993, the day of exercise. This $33,000 will be a positive addition to AMTI.

This recognition of income will also cause the taxpayer to have different bases for regular and AMT purposes. Using the examples shown above, Jean has a basis of $30,000 for regular tax purposes and $63,000 for AMT purposes. Thus, when the stock is sold, a regular tax gain will have to be computed, as will an AMT gain. The difference between the gains will be shown on line 9 of Form 6251.

The general rule of IRC section 83, as shown above, is that the difference between the FMV of the stock and price paid when exercising the option is includible in income in the year exercised. The general rule applies if the stock is substantially vested in the year of exercise. If the stock is not substantially vested in the year of exercise, income is includible for AMT purposes when the option is exercised (if an IRC section 83(b) election is filed, see below) or when the stock becomes substantially vested (not subject to a substantial risk of forfeiture). Treas. Reg. section 1.83-3(c) discusses what constitutes a substantial risk of forfeiture.

If the stock is subject to substantial risk of forfeiture and is, therefore, not subject to AMT for the current year, the taxpayer may elect to recognize this difference in the current year pursuant to IRC section 83(b). Treas. Reg. section 1.83-2 contains the procedures for filing the election. This election must be filed with the IRS within 30 days of the exercise of the ISO. A copy must be sent to the employer and a copy must also be attached to individual's tax return. Note, however, that the election is not effective for regular federal income tax purposes because IRC section 83 does not apply to property transferred pursuant to the exercise of an option governed by the rules of IRC sections 422 and 423. IRC section 83(e)(1); Treas. Reg. section 1.83-7(a).

Under IRC section 56(b)(3), if the taxpayer exercises the options and sells the stock in the same taxable year, he or she must report the sale as a disqualified disposition. Because there is no tax preference, the taxpayer does not include the ISO adjustment in AMT taxable income. This exception was enacted because a taxpayer who reports the full amount of the difference between the stock's basis and the amount realized on the stock's sale in regular taxable income in the year of the stock's sale should not be required to duplicate the income for AMT purposes.

FMV of ISO for AMT

The AMT adjustment is generally the difference between the stock's FMV at exercise and the basis of the stock when the ISO is exercised. The FMV calculation for stock sold on a Security and Exchange Commission (SEC) regulated exchange based on the exercise of the ISO option was held to be based on the average price at which the stock traded on the New York Stock Exchange in the decision of *Kolom v. Commissioner*, 81-1 U.S.T.C. paragraph 9359, 644 F.2d 1282 (9th Cir. 1981), cert. denied, 81-2 U.S.T.C. paragraph 9741.

The Service has not issued any guidelines to determine the FMV of the stock purchased when the ISO involves non-SEC issuances. A call or referral to the engineering group should be made if this issue is present.

Audit Techniques

1. Ask the taxpayer during the initial interview about the types of benefits offered by the employer including stock options. Also ask whether any of these options were exercised during the year under examination.

2. Sales of stock per the taxpayer's Schedule D, Capital Gains or Losses, or per Information Returns Program (IRP) documents should be analyzed to determine if the taxpayer has sold any stock of the employing corporation. This may aid in determining if options were exercised in the current year as well as in subsequent and prior years.

Line 11, Passive Activities

The passive activity loss (PAL) rules were enacted during the Tax Reform Act of 1986 and are effective for tax years beginning after 1986. IRC section 469 defines the rules regarding these laws. These rules apply to individuals, estates, trusts, personal service corporations and closely held C corporations. Generally, under IRC section 469 a loss or credit generated by a passive activity will be limited to the income generated from other passive activities. The excess of the loss or credit is carried forward to future years and is allowed when passive income from passive activities is generated in these years. IRC section 469(b). Losses are also allowed in full in the year of disposition.

IRC section 469(c)(i) defines "passive activity" to mean ". . . any activity (A) which involves the conduct of a trade or business, and (B) in which the taxpayer does not materially participate." A rental activity is also considered a passive activity. It does not need to constitute a trade or business. IRC section 469(c)(2).

IRC section 469(h)(i) defines "material participation" as: "A taxpayer shall be treated as materially participating in an activity only if the taxpayer is involved in the operations of the activity on a basis which is (A) regular, (B) continuous, and (C) substantial." Participation by a spouse is included when applying the rules for materially participating. IRC section 469(h)(5).

Each passive activity is accounted for separately. The income items and loss items are then aggregated. If the losses exceed the income, the resulting loss is the "passive activity loss." IRC section 469(d)(1).

A "passive activity credit" is the sum of business credits derived from passive activities which exceed the taxpayer's regular tax liability for the taxable year allocable to passive activities. IRC section 469 (d)(2). The credits subject to the limitation as passive credits are those in subpart D of part IV of subchapter A, and those in subpart B (other than section 27 (a)) of part IV of the Code.

Income or losses from passive activities do not include earned income, portfolio income (interest, dividends, annuities, royalties, and investment gains), expenses other than interest which are directly related to portfolio income, and interest expense allocable to portfolio income.

IRC section 469(i) provides an exception for individuals who actively participate in rental real estate activities. A taxpayer may deduct losses up to $25,000 (or the amount of credit that is the deduction equivalent of the passive loss). If the taxpayer's adjusted income exceeds $100,000, the amount of the loss is phased out; at $150,000 no loss is allowed. IRC section 469(i)(3)(A).

To qualify for the loss the taxpayer must "actively participate" in the rental activity. The taxpayer must own at least 10 percent of the activity to actively participate. Limited partnership interests are not considered when applying the 10-percent ownership rule. IRC section 469(i)(6)(C). Ownership by a spouse is considered when applying the 10-percent ownership rule. IRC section 469(i)(6)(A).

Some special rules exist for the rehabilitation credit and the low-income housing credit. The $25,000 (in the deduction-equivalent sense) does not require active participation and the threshold for the phase-out is $200,000. IRC section 469 (i)(3)(B), (C).

"Deduction-equivalent" is the amount of credits which, if allowed as a deduction, would reduce the regular tax liability by an amount equal to the tax credits. IRC section 469(j)(6). Assume a taxpayer's income is taxed at the rate of 15 percent and there are no itemized deductions subject to AGI limitations. The deduction equivalent of credits equal to $25,000 is $ 3,750.

If a loss or credit is not allowed in a current year, the loss or credit is suspended and allowed in subsequent years when the taxpayer has passive income. IRC section 469(b). If a taxpayer sells his or her interest, the loss will be allowed in full in the following order: first, against income or gain from the activity for the tax year, including any gain recognized on the disposition; second, against net income or gain for the taxable year from other passive activities; and third, against all other income or gain. IRC section 469(g)(1).

For a more in-depth look at the regular passive loss rules, see the Passive Activity Loss Audit Techniques Guide (Training 3149-115). The guide is available from the IRS Internet web site at www.irs.ustreas.gov.

IRC section 58(b) discusses the AMT provisions when dealing with passive activity losses. This section states that IRC section 469 will apply for AMT purposes except that the adjustments of IRC sections 56 and 57 shall apply, the phase-in of losses prior to 1990 will not apply and the passive activity loss will be computed without regard to qualified housing interest (as found in IRC section 56(e)).

The easiest way to apply the AMT rules, as they relate to passive activity losses, is to prepare a separate loss computation solely for AMT purposes. The difference between this computation and the computation for regular tax purposes will be your adjustment on Form 6251. All items of adjustment and tax preference items relating to the passive activity will have to be considered when computing the AMT passive activity loss. Depreciation will be the most common area requiring recomputation. However, all adjustments must be considered and applied when applicable.

EXAMPLE 13: Don actively participates in a rental real estate activity and incurs the following expenses:

	Regular Tax	AMT
Income	$ 50,000	$50,000
Real Estate Taxes	($9,000)	($9,000)
Wages	($11,000)	($11,000)
Operating Expenses	($25,000)	($25,000)
Depreciation (27.5 Years) Basis = $400,000	($14,544)	
Depreciation (40 Years)		($10,000)
Total Losses	($9,544)	($ 5,000)
	======	======

The adjustment required to be shown on line 11 of Form 6251 will be the difference between the two amounts shown above, an add back of $4,544. This depreciation adjustment must be made as a passive loss adjustment on line 11 and will not be considered on the line 8 adjustment depreciation. This is true of all IRC section 56 and 57 adjustments required to be made for passive activity losses.

EXAMPLE 14: Assume the same facts in Example 13, except that the activity is not a rental real estate activity. For regular tax purposes the taxpayer will have a suspended loss of ($ 9,544) and a suspended AMT loss of ($ 5,000). No adjustment is made on Form 6251 in the current year for these suspended losses. This shows the importance of the taxpayer's maintaining two sets of records: one for regular tax purposes and one for AMT purposes.

Note: Alternative Minimum Tax Net Operating Losses (AMTNOL) have not yet been discussed, but it is important at this time to bring up the point addressed by Technical Advice Memorandum 9152004 which states that an AMTNOL from a post-1986 tax year carried to a pre-1987 tax year will include for AMT purposes the disallowance of the post-1986 Alternative Minimum Tax Passive Activity Loss (AMTPAL). Any passive activity loss that is disallowed for AMT purposes will not be included in any AMTNOL generated in the year of disallowance.

Special rules apply regarding passive farm activity losses. These losses are subject to rules IRC section 58(a), which specifically deals with farm losses. The rules of IRC section 58(b) which deal with general passive activities may also apply. For AMTI purposes, any loss deduction from a "tax shelter farm activity" will not be allowed. IRC section 58(a)(1)(A). An insolvent taxpayer (one whose liabilities exceed his or her assets), will be allowed to reduce his or her disallowed loss by the amount of his or her insolvency. IRC section 58 (c)(1)(A). The disallowed loss is carried over into future years and deductible against any passive income generated in those years from that specific activity. A passive farm activity loss is different from general passive losses in that losses carried over from year to year can be offset only against income from that same activity in future years. IRC section 58(a)(1)(B). However, in the year of disposition the entire loss is allowed and can be used to offset other passive income as well as earned income. IRC section 58(c)(2).

A "tax shelter farming activity" can be either a farming syndicate, as defined in IRC section 464(c), or any farming activity which meets the general passive rules of IRC section 469(c). IRC section 58(a)(2). IRC section 464(c) defines a "Farming Syndicate" as:

> *** (A) a partnership or any other enterprise other than a corporation which is not an S corporation engaged in the trade or business of farming, if at any time interest in such partnership or enterprise have been offered for sale in any offering required to be registered with any Federal or State agency having authority to regulate the offering of securities for sale, or (B) a partnership or any other enterprise other than a corporation which is not an S corporation engaged in the trade or business of farming, if more than 35 percent of the losses during any period are allocable to limited partners or limited entrepreneurs.

IRC section 464(c)(2) provides an exception for those taxpayers who are characterized as a farming syndicate because more than 35-percent loss allocation is to limited partners or entrepreneurs. This exception exempts them (1) if they previously actively participated in the management of any trade or business of farming during the last 5 years or (2) if their personal residence is on the farm which is farmed by the entity.

Thus, passive farming activities are first subject to adjustment under IRC section 58(a). If the loss is not disallowed for AMT under this section, it will then need to be considered under the general passive rules for AMT under IRC section 58(b). The rules for nonpassive tax shelter farm activities will be discussed in the rules for line 14m.

Audit Techniques

1. If the taxpayer shows passive losses for regular tax purposes, he or she should also have a separate schedule showing AMT passive losses. If the AMT schedule is not shown on the return, ask the taxpayer to supply the schedule. If no schedule exists, the nature of the activity should be considered. Most activities will have some assets which indicate at the minimum a depreciation adjustment would exist. Each AMT preference and adjustment item must be considered as it relates to the activity. If any adjustments exist, prepare a separate AMT schedule.
2. The adjustments for the passive activity losses must be reflected on line 11. Thus, if a taxpayer explains the passive adjustments are on other lines of Form 6251, verify this and inform the taxpayer of the correct format.
3. If a taxpayer is involved in a tax shelter farm activity, an AMT adjustment will be made on line 11 or line 14m. Verify the adjustment.

Line 12, Beneficiaries of Estates and Trusts

This amount applies to beneficiaries of estates or trusts. The estate or trust will identify in total the adjustments for AMT purposes of the estate or trust on line 8 of Schedule K-1, (Beneficiary’s Share of Income Deductions, Credits, etc.), for 1993 through 1996 (line 9 for 1997 and 1998). When examining a taxpayer who is a beneficiary of an estate, analyze Form K-1 to determine that the proper amount was included on line 12 of Form 6251.

Audit Technique

Ask the taxpayer for Schedules K-1 from the trust or estate. Verify that the AMT adjustments and preference items were included on the beneficiary's Form 6251. If it appears that estate or trust should have some AMT adjustments and none are present, pursue the issue further.

Line 13, Tax-exempt Interest from Private Activity Bonds Issued after 8/7/86

IRC section 57(a)(5)(A) lists tax-exempt interest as an item of tax preference for AMT purposes. This preference item involves specified private activity bonds paying interest that is excludable from gross income under IRC section 103(a).

Generally, interest on obligations of state or local governments is excluded from income under IRC section 103(a). This exclusion does not apply to a private activity bond unless that bond is a qualified private activity bond. IRC section 103(b)(1).

IRC section 141(a) defines private activity bonds. Generally, a bond is a private activity bond if it meets (1) both the private use and private payment or security test under IRC section 141(b), or (2) the private loan financing test under IRC section 141(c). A qualified private activity bond is defined in IRC section 141(e).

For AMT purposes, IRC section 57(a)(5)(A) states that interest from specified private activity bonds and deductions not otherwise allowable because of tax-exempt status must be included in income for AMT purposes, with the exceptions of qualified 501(c)(3) bonds and any refunding bond (whether a current or advance refunding) if the refunded bond (or in the case of a series of refunding, the original bond) was issued before August 8, 1986. In addition, IRC section 57(a)(5)(B) provides that "*** any exempt-interest dividend (as defined in section 852(b)(5)(A)) shall be treated as interest on a specified private activity bond to the extent of its proportionate share of the interest on such bonds received by the company paying such dividend."

EXAMPLE 15: Connie purchases qualified private activity bonds in 1990. In 1993 these bonds generated $40,000 in interest. For 1993 Connie will be required to include for AMT purposes the $ 40,000 as income. This amount will be shown as a positive figure on line 13.

As discussed above in regard to line 7, this interest is reduced by any deduction (not already deducted for regular tax purposes) which would be allowed if the amounts are includible in income. Thus, for regular tax purposes, interest on tax-exempt bonds is not required to be included in income and no investment interest deduction is allowed.

However, for AMT purposes, since the amount is required to be included in income, the corresponding interest deduction would be allowed.

Audit Techniques

1. Question the taxpayer during the initial interview regarding all investments, including stocks and bonds.
2. When analyzing the income of the taxpayer, any sales of bonds during the year should be analyzed to determine if any of these bonds are specified private activity bonds. Any interest earned on these bonds must be included for AMT purposes. This may also alert you to other bonds not yet sold. But the interest from those bonds must be included for AMT purposes.

Other Items of Adjustment and Tax Preference Items

Line 14a, Charitable Contributions (For Tax Years 1993–1997)

For charitable contributions of personal property made after June 30, 1992, and for charitable contributions of other property made after December 31, 1992, no tax preference item adjustment is required. However, prior to those times, charitable contributions of appreciated property were tax preference items for AMT purposes. The law that is applicable is the law of the year of contribution. Thus, a carryover (carryforward) of contributions from tax years prior to 1993 will be required to conform with the laws in effect in the year of contribution. For a discussion of the law prior to 1993 see Chapter 5.

Audit Technique

If the taxpayer has a charitable contribution carryover from 1992 or earlier, the nature of this contribution should be determined. If the contribution consists of appreciated property, the AMT rules discussed in Chapter 5 should be followed.

Line 14b, Circulation Expenditures (For Tax Years 1993–1997; Line 14a for Tax Year 1998)

For regular tax purposes, IRC section 173(a) allows a taxpayer to deduct currently all expenses to establish, maintain or increase the circulation of a newspaper, magazine or other periodical for the tax year the expenses are incurred. Without this Code section, the costs would have to be capitalized under IRC section 263. However, if the expenditures are for land, depreciable property, or the acquisition of circulation through the purchase of any part of the business of another publication, they will not be allowed as a current deduction.

Taxpayers are not required to expense circulation costs for regular tax purposes. Instead, they may elect to capitalize costs for the portion of circulation expenses which would normally be chargeable to a capital account. Treas. Reg. section 1.173-1(c)(1) provides the following example. If a newspaper normally employs five people to obtain renewals of subscriptions, the expenses attributable to obtaining the renewals are not chargeable to a capital account. If, however, the newspaper in a campaign to increase circulation employs 20 additional people for a limited time to solicit new subscriptions, these expenses would be properly chargeable to a capital account. This election is revokable only with the Commissioner's consent.

For AMT purposes, under IRC section 56(b)(2)(A)(i), circulation expenditures must be capitalized and amortized over a 3-year period beginning with the year incurred. These expenses will result in a positive adjustment to AMT in the year the expenses are incurred and a downward adjustment in the following 2 years.

EXAMPLE 16: Jackie owns and operates a small town newspaper. She incurs circulation expenditures of $1,000 in 1994. (These expenditures were not incurred in the purchase of a business or a depreciable property). She elects to take the expenditures as a current deduction under IRC section 173. For AMT purposes, a deduction of $333 would be allowed in 1994, 1995, and 1996. Thus, for 1994 AMT purposes a positive adjustment of $ 667 would be required to be made. If no additional circulation expenses were incurred in 1995 and 1996, Jackie would have additional deductions of $333 in each year for AMT purposes. Therefore, line 14b of Form 6251 would show negative adjustments of $333 in 1995 and 1996.

Under IRC section 56(b)(2)(B), if a loss occurs regarding expenses deducted under IRC section 173(a), the unamortized portion of these expenses may be allowed for AMT purposes. The AMT deduction is limited to the lesser of the amount allowable as a loss under IRC section 165(a), if the circulation expenditure had remained capitalized, or the amount of such expenditures which have not previously been amortized for AMT.

Taxpayers can also make an election under IRC section 59(e) to capitalize and amortize the expenditures ratably over a 3-year period beginning with the taxable year in which the expenses are incurred in computing their regular taxable income. If an IRC section 59(e) election is made, there will be no AMT adjustment.

Audit Techniques

1. Analyze the tax return to determine if an election under IRC section 173(a) has been made. If it has, Form 6251 should have a corresponding AMT adjustment on line 14b, (line 14a for the 1998 tax year). The circulation expense adjustment applies to amounts paid or incurred after December 31, 1986.
2. If the taxpayer's business involves publications, and, therefore, lends itself to the nature of these expenditures, ask the taxpayer if any circulation expenditures have been incurred and, if so, how they were treated on the tax return.

14c, Depletion (For Tax Years 1993–1997; Line 14b for Tax Year 1998)

For regular tax purposes, taxpayers who are involved in mining, oil, gas, timber and other natural resources are allowed a depletion deduction per IRC section 611(a). The deduction is allowable only for exhaustible property in which the taxpayer has an economic interest.

Depletion deductions may be taken using one of the two available methods: cost depletion or percentage depletion.

Cost depletion is based on available units of the resource and the taxpayer's cost of the resource. At the beginning of each year, the taxpayer calculates his remaining cost of the resource and divides it by the remaining units available for sale. This amount is then multiplied by the number of units sold during the year. Once the taxpayer has taken depletion expenses equal to the amount of his or her cost, he or she is not allowed any more depletion deductions.

Percentage depletion takes percentages assigned by the Internal Revenue Code for various minerals and multiplies them by gross income of the property, subject to a maximum of 50 percent of the taxable income excluding the depletion deduction. IRC section 613. This can result in depletion deductions in excess of the cost of the resource.

If a taxpayer is using the percentage depletion method, he or she may be subject to a tax preference item for AMT purposes. Per IRC section 57(a)(1), the amount of the preference item will be the excess of the deduction for depletion allowable under IRC section 611 for the taxable year over the adjusted basis of the property at the end of the taxable year. This preference item is computed on a property by property basis and is not applicable to percentage depletion for oil and gas wells of independent producers and royalty owners for tax years beginning after 1992.

Audit Technique

If the taxpayer is involved in oil or gas (excluding, for tax years after 1992, small retailers and refiners of oil or gas), ask the taxpayer about the type of depletion method used. If the taxpayer is on the percentage depletion method, the basis for each property should be identified and any depletion in excess of basis should be included on line 14c of Form 6251 (line 14b for the 1998 tax year). Adjusted basis for purposes of the depletion preference should not include tangible costs which are depreciable in nature.

Line 14d, (Pre–1987) Depreciation (For Tax Years 1993–1997; Line 14c for Tax Year 1998)

For property placed in service before 1987 for which the current AMT rules do not apply (IRC section 56(a)(1)), the law in effect before the enactment of the Tax Reform Act of 1986 will apply. These items were found in IRC sections 57(a)(2), 57(a)(3), 57(a)(4), and 57(a)(12).

IRC section 57(a)(2) discussed deductions taken on real property as defined in IRC section 1250(c). The tax preference item for these properties is the excess of accelerated depreciation deductions over the amount of straight-line depreciation computed using the properties' useful lives.

IRC section 57(a)(3) discussed the tax preference items for non-ACRS leased personal property. Again the amount of the tax preference item was equal to the excess of accelerated depreciation over the amount of straight-line depreciation computed using the properties' useful lives.

IRC section 57 (a)(4) discussed the tax preference items relating to pollution control facilities. Similar to current law, the tax preference item was the excess of amortization allowed under the 60-month write-off election defined in IRC section 169 over the depreciation which would otherwise be allowed under IRC section 167.

IRC section 57 (a)(12)(A) discussed the tax preference items taken on leased recovery property (other than 19 year real property and low income housing property). The tax preference item was the difference between the amount of depreciation taken under IRC section 168(a) over the amount of straight-line depreciation computed using the following chart:

Type of Property	AMT Recovery Period
3-Year Property	5 Years
5-Year Property	8 Years
10-year Property	15 Years
15-Year Public Utility Property	22 Years

IRC section 57 (a)(12)(B) discussed the tax preference items taken on 19 year real property or low income housing. The tax preference items for these properties were the amount of depreciation taken under IRC section 168(a) over the amount of straight-line depreciation using 19 years for real property and 15 years for low income housing property.

Audit Technique

The taxpayer's depreciation schedule should be examined to determine (1) when property was placed in service and (2) the method of depreciation used for regular tax purposes and for AMT purposes. As discussed under post-1986 depreciation, the taxpayer should be keeping separate records for AMT and regular tax purposes. If the taxpayer is not, AMT depreciation must be computed using the applicable life and recovery method for AMT purposes, and AMT income will be adjusted accordingly.

Line 14e, Installment Sales (For Tax Years 1993-1997; Line 14d for Tax Year 1998)

IRC section 453 deals with installment sales. IRC section 453(b)(2)(A) specifically prohibits dealers of property from using the installment method for reporting sales of inventory. Dealers are required to report all profits in the year of sale. Thus, for AMT purposes no adjustment would need to be made per IRC section 56(a)(6).

IRC section 453(l)(2) provides exceptions to the general installment sale of dealers rule. These include sales of property used or produced in a farming trade or business under IRC section 2032A(e)(4) or (5) and for certain timeshare and residential lots. For farm property sold as inventory under IRC section 1221(1), the installment method will not be allowed to be used for AMT purposes. These taxpayers will be required to report all profits in the year of sale for AMT purposes. IRC section 453(l)(2)(B) specifically excludes the sale of certain time share and residential lots as defined in IRC section 453(l)(2)(B), and thus no AMT adjustment is required for these items.

EXAMPLE 17: Robin is a farmer who sold cattle on the installment method in 1993. The basis of the cattle was $100,000 and the amount of the sale was $200,000. The gross profit percentage is 50 percent ($100,000 /$200,000). She received $25,000 in 1993. For regular tax purposes, she reports $12,500 (the payment received of $25,000 multiplied by the gross profit percentage of 50 percent). For AMT purposes, she must report all of the gain, and she will have an AMT adjustment of $87,500 ($100,000 gain less the $12,500 reported).

Audit Technique

When auditing farmers, if inventory items (as defined under IRC section 1221(1)) are being sold on the installment method, the taxpayer should have a corresponding AMT adjustment in the year of sale and negative adjustments in subsequent years.

Line 14f, Intangible Drilling Costs (For Tax Years 1993–1997; Line 14e for Tax Year 1998)

(***Note that for the 1998 tax year, line 14f is Large Partnerships, discussed in the next topic.)***

When accounting for Intangible Drilling Costs (IDCs) the taxpayer can either capitalize the costs or deduct the items as current year expenses. IRC section 263(c). Per Treas. Reg. section 1.612-5, IDCs are those costs which, in and of themselves, have no salvage value. These include all expenditures made by an operator for wages, fuel, repairs, hauling, and supplies, etc,. incident to and necessary for the drilling of wells and the preparation of wells for the production of geothermal steam or hot water.

This includes the above items used in (1) the drilling, shooting, and cleaning of wells, (2) in such clearing of ground, draining, road making, surveying, and geological work as are necessary in preparation for the drilling of wells, and (3) in the construction of such derricks, tanks, pipeline, and other physical structures as are necessary for the drilling of wells and the preparation of wells for the production of geothermal steam or hot water. If the expenses are incurred in the production of physical property which has a salvage value, the individual expenses will still not be considered to have a salvage value.

IDCs also include costs incurred in connection with the installation of tangible equipment for the drilling of wells and the preparation of wells for production. The equipment itself must be capitalized and depreciated. However, the installation costs of these items will be considered an IDC and may be used as a current deduction.

Once the installation of production equipment begins, the taxpayer is no longer allowed any IDCs. At this point the normal rules of capitalization apply. Thus, if labor is incurred for the installation of a piece of equipment in production, this cost will be required to be capitalized as a part of the equipment cost. However, labor for the day-to-day operations of the oil well itself will be considered a current expense.

If the taxpayer elects to capitalize the cost and the well later becomes non-productive, the loss will be deducted in the year that the well becomes worthless. If the taxpayer elects to capitalize the cost and the well is productive, the capitalized cost will be recovered through depreciation (if the cost was incurred for physical property) or depletion.

IRC section 57(a)(2) discusses the AMT rules surrounding IDCs. The tax preference item is the amount by which the excess IDCs arising in the taxable year are greater than 65 percent of the net income of the taxpayer from oil, gas and geothermal properties for the taxable year. Net income from oil, gas, and geothermal properties is the gross income from all the taxpayer's oil, gas, or geothermal properties less any deductions allocable to these properties reduced by the excess IDCs.

For tax years beginning after 1992, this preference item will apply only to taxpayers who are integrated oil companies. IRC section 291(b)(4). However, the reduction in AMTI because of this law change may not exceed 40 percent (30 percent in cases of taxable years beginning in 1993) of the AMTI computed as if the tax preference item for IDC had not been changed. Prior to this law change, the excess IDC tax preference item applied to all taxpayers with oil, gas, or geothermal properties.

Excess IDCs are the excess of the amount of intangible drilling and development costs paid or incurred with respect to oil, gas or geothermal properties that the taxpayer elects to expense under IRC section 263(c) over the amount that would be allowed for the taxable year if the costs had been capitalized and amortized under one of the methods provided in IRC section 57(b). The two methods available under IRC section 57(b) are (1) a ratable amortization over a 120-month period beginning with the first month is which the production begins, or (2) at the election of the taxpayer, any method permitted for determining cost depletion with respect to a well.

If the taxpayer elects to compute excess IDCs under IRC section 57(b)(2) using the cost depletion method, the election must be made in the year that the IDCs are paid or incurred. This election must be made on a well-to-well basis. This election can be made to arrive at excess IDCs, even if the taxpayer uses another method to arrive at taxable income for regular tax purposes. Tem. Treas. Reg. section 7.57(d)-1(b).

When computing the excess IDCs using the cost depletion method under IRC section 57(b), both depreciable property and depletable property are considered.

The IRC section 59(e) election is also available to the taxpayer. This election allows the taxpayer to deduct the IDCs over a 60-month period beginning with the month the IDCs are paid or incurred. (The write-off period was 10 years instead of 60 months before 1989. The change to 60 months is effective for costs paid or incurred in tax years beginning after 1989.) If the taxpayer makes this election, no preference item will result. This election is made on a year-to-year basis and is revocable only with the consent of the secretary. IRC section 59(e)(4)(B).

EXAMPLE 18: During 1991, the taxpayer incurs IDCs of $100,000 and elects to take a current deduction for these costs under IRC section 263(a). The taxpayer's gross income is $90,000 and operating expenses are $60,000. Production began on the wells in April, 1991.

(1) calculate the excess IDCs. IDCs currently deducted are $100,000, less the allowed amortization $7,500 ($100,000/120 months = $833 per month at 9 months) equals excess IDCs of $92,500.

(2) calculate the net income. Gross income is $90,000. Deductions include IDCs of $100,000, operating expenses of $60,000, and depletion of $13,500, for total allocable expenses of $173,500 less excess IDCs of $92,500 which equals $81,000. Net income is equal to $9,000.

(3) compute the tax preference item as the Excess IDC of $92,500 less 60 percent of net income $5,850 (65 percent x $9,000), which equals $86,650.

A taxpayer should, at the end of each year, determine whether a well is productive or nonproductive. A nonproductive well is not considered when computing the tax preference item. A nonproductive well is one which is plugged and abandoned without producing a significant amount of oil or gas for a substantial period of time. The IDCs relating to a nonproductive well may be capitalized and deducted at the time the well is considered nonproductive or written off as a current deduction. Treas. Reg. section 1.612-4(b)(4). If the taxpayer considers a well productive at year end and later discovers it to be a nonproductive well, the taxpayer may file an amended return.

Audit Technique

If the taxpayer is involved in the oil, gas, or geothermal industry, the treatment of excess IDCs should be established during the audit and a determination made as to whether any AMT adjustment is needed.

Line 14f, Large Partnerships (For Tax Year 1998)

For tax years beginning after December 31, 1997, partners in an electing Large Partnership must take into account amounts from Schedule K-1 (Form 1065-B), *Partner's Share of Income (Loss) From an Electing Large Partnership,* as an adjustment on line 11 or line 14f of Form 6251. The amount from Schedule K-1 (Form 1065-B), box 6, should be entered on line 14f of Form 6251. The partners must also take into account an amount from Schedule K-1 (Form 1065-B) box 5, on Form 6251, line 11. IRC section 772(b)(5).

Line 14g, Long-term Contracts

Under IRC section 460(f), which provides the general rules regarding long-term contracts, the taxpayer must use the percentage of completion method for contracts which are for the manufacture, building, installation, or construction of any property, if the contract is not completed within the taxable year it was entered into. A contract for the manufacture of property must be for a unique item of a type that is not normally included in a taxpayer's finished goods inventory and for any item requiring longer than 12 months to complete.

There are also exceptions for certain construction contracts. Taxpayers, whose average annual gross receipts for the 3 preceding taxable years are $10,000,000 or less and who estimate at the time the contract is entered into that such contract will be completed within a 2-year period, will not be required to use the percentage of completion method of accounting for their contracts. Home construction contractors are also not required to use percentage of completion to account for their contracts. These contractors may use any other available method including completed contract, accrual and cash. See the Audit Techniques Guide on Construction Industry (Training 3147-123).

To compute the income under the percentage of completion method, the "percentage complete" must be calculated. This percentage is computed on a contract by contract basis by dividing actual costs of the contract to the estimated total contract costs. Notice 87-61. This method is known as the cost-to-cost method. A taxpayer can also elect to use the "simplified cost-to-cost method." IRC section 460(b)(3)(A). To use this method, all contracts must be computed under the percentage of completion method for all items under all long-term contracts in a trade or business. Notice 87-61; Treas. Reg. section 1.451-3(a)(1). Under this method, (1) direct material costs and direct labor costs and depreciation, (2) amortization and cost recovery allowances on equipment and facilities directly used to produce or construct the contract's subject matter over the estimated contract costs are used to compute the percentage of completion. Notice 87-61.

For AMT purposes, under IRC section 56(a)(3), all taxable income from long-term contracts entered into by the taxpayer on or after March 1, 1986, must be computed using the percentage of completion method. The only exception to this rule is for home construction contracts. When computing the percentage of completion for AMT purposes, all AMT adjustments must be made. Thus, if the taxpayer has depreciable items which require an AMT adjustment, the depreciation for AMT will be used when computing the percentage of completion.

EXAMPLE 19: During tax year 1993, Carol was a commercial contractor with gross receipts under $10,000,000 for the last 3 years. She completes her contracts within 2 years. For regular tax purposes she uses the completed contract method to report income. However, for AMT purposes she is required to use the percentage of completion method. If her income under the completed contract method was $125,000 and under the percentage of completion method would be $200,000, the AMT adjustment for 1993 would be $75,000.

An election is available to taxpayers, which allows them to use their regular method (cost-to-cost or simplified cost-to-cost) to compute the percentage complete. IRC section

460(b)(3). This election is, however, used only to compute the percentage complete. When computing the amount of income generated from a particular contract, the taxpayer must use the costs as computed for AMT purposes. Notice 87-61. Thus, the taxpayer could use the regular cost-to-cost method (using depreciation as allowed for regular tax purposes) in arriving at the percentage complete, but when computing the actual amount of expenses for the contract, the depreciation expense would have to be computed using the depreciation as adjusted for AMT purposes. Therefore, whether the taxpayer uses the general AMT rules or the election, the taxpayer should have an adjustment to AMT.

Audit Technique

All taxpayers in the contracting industry, with the exception of home construction contractors, are required to use the percentage of completion method for AMT purposes. Thus, with the exception of home construction contractors, contractors could have an adjustment for AMT purposes. Larger contractors who are required to use percentage of completion for regular tax also could have an adjustment due to the AMT percentage of completion including all AMT preference items and adjustments such as depreciation. These adjustments will affect the percent complete and costs to date of the projects.

Line 14h, Loss Limitations

If the taxpayer has a loss that is limited on his or her tax return, an AMT computation will also be required. Passive losses are limited but are computed separately on line 11 of Form 6251, as are tax shelter farm activities (line 14m) (or for 1998, line 14n). Examples of loss limitations reported on line 14h are losses limited due to basis rules in an S-Corporation or partnership, or the at-risk rules applicable to losses. Losses limited under IRC section 280A may also be affected. These losses should be recomputed taking into account all other AMT preference items and adjustments. Depreciation is usually the most common item affecting the change in loss limitations; however depending on the nature of the item limited, any of the adjustments or preference items could have an effect on the loss limitation for AMT purposes. Any losses reported on the taxpayer's return subject to limitations should be analyzed to determine if an AMT adjustment is needed.

EXAMPLE 20: Chris is at-risk for a property in the amount of $100,000 in 1993. For regular tax purposes the property has a loss of $125,000. The loss will be limited to the amount at risk of $100,000. After considering all AMT adjustments and preferences, the property has an AMT loss of $90,000, all of which will be deductible in 1993. If in 1994 he has a regular loss of $30,000 and an AMT loss of $15,000, he will be allowed no loss for regular tax purposes and a $10,000 loss for AMT purposes. The 1993 return will show a positive adjustment of $10,000 and the 1994 return will show a negative adjustment or additional loss of $10,000. The suspended loss for regular tax purposes will be $55,000 ($25,000 for 1993 plus the $30,000 for 1994) and for AMT purposes will be $5,000 (no suspended loss in 1993 and $5,000 in 1994).

Audit Technique

If the taxpayer is involved in any activities in which losses may be limited due to office in the home, basis or at-risk provisions, a separate calculation should be made for AMT and regular tax purposes. The taxpayer should be asked for this computation. If none exists, a computation should be prepared and AMT adjusted accordingly.

Line 14i, Mining Costs

For regular tax purposes, the taxpayer is allowed an election to take a current expense deduction for mining exploration and development costs. IRC sections 616 and 617.

Mining development costs are the costs incurred to determine the existence, location, extent, or quality of any deposit of ore or other mineral (other than oil or gas). If the taxpayer does not elect to deduct the costs currently, they will be capitalized and written off through depletion. This election is only revocable with the Commissioner's consent. IRC section 617.

If the property is disposed of and the costs written off as current deductions, the costs must be recaptured as ordinary income. Once a mine reaches production, any costs deducted as current expenses also must be recaptured under IRC section 617(b).

After deposits of minerals or ore are discovered in sufficient quality and quantity that a taxpayer may justify commercial exploitation, the development stage of mineral mining begins based on Treas. Reg. section 1.617-1(a). Rev. Rul. 69-540 defines developmental expenditures as those resulting directly from the mining process or activity of making the mineral in place more accessible for production operations through the removal of material, by driving shafts, tunnels, etc., and similar processes.

IRC section 616(a) allows the taxpayer a current deduction for these amounts. However under IRC section 616(b), the taxpayer may elect to capitalize the costs. The deduction is reported ratably as the minerals are produced or sold. The amortization deduction is equal to the excess of development costs over the net receipts in each taxable year. These costs are accounted for separately and are not capitalized for regular depletion purposes. The election is made on a mine-to-mine basis and applies only to those expenses incurred in the taxable year it is made. The election is irrevocable.

For further discussion of the regular tax rules regarding mining exploration and development costs, see IRC sections 616 and 617 and the corresponding Treasury Regulation sections.

For AMT purposes, under IRC section 56(a)(2), mining development and exploration costs paid or incurred after 1986 and currently deducted under IRC section 616(a) and IRC section 617(a) must be capitalized and amortized over a 10-year period beginning with the year the expenses are incurred. If a mining property becomes worthless or is abandoned, the deductible loss is equal to the lesser of the amount of unamortized costs or the amount of loss that would be allowed under IRC section 165 had the costs remained capitalized.

EXAMPLE 21: Candy makes the IRC section 616(a) and 617(a)(1) election to currently deduct mining exploration and development costs. For 1993, she deducts $20,000 of these costs. For AMT purposes, she is allowed 10 percent of these costs ($2,000). For 1993 she will have a positive adjustment of $18,000. In each of the subsequent 9 years she will have a negative adjustment of $2,000 allowing 1/10 of the costs in each year.

Similar to the election available for circulation costs and research and experimental expenditures, a regular tax election available to a taxpayer for mining exploration and development costs is the election to amortize such expenses ratably over a ten-year period based on IRC section 59(e). If an IRC section 59(e) election is made, such costs are excluded from AMT based on IRC section 59(e)(6). IRC section 59(e) can be elected for all or a portion of a specific mine's exploration or development expenses.

Audit Technique

If the taxpayer is involved in the mining industry, the tax treatment of each mine and what elections, if any, the taxpayer has made should be determined. If the taxpayer currently deducts the mining exploration and development costs, AMT adjustments must be made. The taxpayer should have separate records for regular and AMT purposes for each mine.

Line 14j, Patron's Adjustment (For Tax Years 1994–1998)

Distributions received from cooperatives should be included in income, unless the distributions are nontaxable. The total AMT patronage dividend and allocation adjustment should be reported.

Line 14k, Pollution Control Facilities (For Tax Years 1994–1998; Line 14j for Tax Year 1993)

Under the regular tax rules of IRC section 169(a), a taxpayer is allowed to amortize the cost of a certified pollution control facility over a 60-month period. This election applies to tangible depreciable property. If elected, this amortization deduction is substituted for any allowable depreciation.

IRC section 56(a)(5) describes the method applicable for AMT purposes. For property placed into service after December 31, 1986, the deduction determinable under IRC section 169 shall be determined under the alternative system of IRC section 168(g). The pollution control adjustment is determined by substituting the recomputed AMT amortization for the regular tax deduction. Thus, the difference between the two amounts will be the amount of the AMT adjustment.

Upon disposition of the pollution control facility, a taxpayer is required to compute a separate regular tax and AMT gain/loss taking into account prior regular tax and AMT accumulated amortization.

EXAMPLE 22: Ann has incurred $1,000,000 costs relating to a certified pollution control facility for 1993. The facility was placed in service in February 1993. For regular tax purposes, the costs will be amortized over a 60-month period. Thus, for 1993, she will be allowed a deduction of $183,333 ($16,667 x 11 months). For AMT purposes, she must use the alternative method per IRC section 168(g). Assuming that the property is 12-year property, using straight-line depreciation with a half-year convention, she will be allowed $41,667 for AMT purposes. Therefore, for AMT purposes, for 1993, Ann will have a positive AMT adjustment of $141,666.

Audit Technique

If a taxpayer is deducting amounts related to certified pollution control facilities, determine if she has filed an election under IRC section 169. If so, an AMT adjustment should be present. Again, the taxpayer should have separate records for amortization deductions for regular tax purposes and AMT purposes.

Line 14l, Research and Experimental Expenditures (For Tax Years 1994–1998; Line 14k for Tax Year 1993)

IRC section 174(a) allows a current year deduction for research and experimental (R&E) costs. R&E expenditures are defined in Treas. Reg. section 1.174-2(a)(1) as expenditures incurred in connection with the taxpayer's trade or business which represent research and development costs in the experimental or laboratory sense, and includes all such costs incidental to the development of an experimental or pilot model, a plant process, a patent, a formula, an invention, or similar property.

To fully deduct the costs under IRC section 174(a), the taxpayer treats the costs as current deductions for the first taxable year the costs are incurred.

IRC section 174(b) allows the taxpayer to elect to amortize R&E expenses over a period of at least 60 months. If the property resulting from the expenditures has a useful life, amortization is required over the useful life. Treas. Reg. section 1.174-4(a)(2). If the election is made under IRC section 174(b), it will apply to all subsequent tax years, unless the Commissioner's permission to change methods is granted.

If the expenses incurred result in the development of an actual depreciable asset, the remaining unamortized R&E expenses must be recovered as a depreciation deduction over the property's useful life.

An AMT adjustment is required only if the taxpayer elects to deduct the costs as current year costs under IRC section 174(a). For AMT purposes, under IRC section 56(b)(2)(A)(ii), the taxpayer must capitalize these costs and amortize them ratably over a 10-year period beginning with the year the costs were incurred, unless the taxpayer qualifies for the material participation exception discussed in IRC section 56(b)(2)(B).

If the taxpayer suffers a loss with respect to the R&E costs deducted under IRC section 174(a), for AMT purposes, the entire unamortized R&E costs are deductible in the year of the loss. This loss is limited to the lesser of the amount of loss allowable under IRC section 165(a) if the costs had been capitalized, or the amount of the expenditures that have not previously been amortized.

EXAMPLE 23: Mark has research and experimental expenditures which he has elected under IRC section 174(a) to deduct currently. His costs are $10,000 for 1993. For AMT purposes, he will be allowed $1,000 each year for the next 10 years. In 1993 he will have a positive AMT adjustment of $9,000 and for the next 9 years he will have a negative $1,000 adjustment.

If the taxpayer elects to capitalize and amortize R&E expenses pursuant to IRC section 174(b), no AMT adjustment is necessary. An election is also available to the taxpayer under IRC section 59(e) to capitalize and amortize these costs ratably over a 10-year period beginning with the year the costs were first incurred for regular tax purposes. This election would reduce the burden on taxpayers because they would not have to make an AMT adjustment. The election under IRC section 59(e) is a year-to-year election made by the taxpayer. The election may be revoked only with the consent of the Secretary. IRC section 59(e)(4)(B).

EXAMPLE 24: Assume the same facts in Example 23, except that Mark elects under IRC section 59(e) to capitalize and amortize the costs. Therefore, for both regular tax purposes and AMT purposes, Mark will be allowed $1,000 each year for 10 years. Since the deduction for regular tax purposes and AMT purposes is the same, there will be no AMT adjustment.

For tax years after 1990, IRC section 56(b)(2)(D) allows a taxpayer to avoid the AMT R&E if he or she materially participates in the activity. The rules of material participation are the same as the passive activity rules of IRC section 469(h). The taxpayer must participate in a regular, continuous and substantial manner. This law will affect only those who are actually a part of the inventing process. Most investors will not meet these rules.

Audit Technique

If the taxpayer is taking a deduction for research and experimental costs, any elections made by the taxpayer should be determined. If current deductions are being taken, the taxpayer should have separate computations for regular and AMT purposes.

Line 14m, Tax Shelter Farm Activities (For Tax Years 1994–1997; Line 14l for Tax Year 1993; Line 14n for Tax Year 1998)

Note that for the 1998 tax year, line 14m is Section 1202 exclusion. This is discussed in the next topic.

If a taxpayer is involved in a tax shelter farm activity which is not a passive activity, an adjustment for AMT purposes must be made. Tax shelter farm activities were discussed with the passive activity loss adjustment on line 11. Remember, if a tax shelter farm activity is considered passive, it must be reported with all other passive items on line 11. Thus, line 14m deals only with non-passive tax shelter farm activities.

The income or loss from each tax shelter farm activity must be recomputed using all AMT preference items and adjustments found in IRC sections 56, 57, and 58. If the activity has depreciable property, the AMT depreciation must be used in arriving at the AMT income or loss amount. Per IRC section 58(a), no loss will be allowed on any tax shelter farm activity for AMT purposes unless the taxpayer is insolvent, in which case a loss will be allowed up to the amount of insolvency. Income or loss for each activity (as defined in IRC section 469) is computed on a separate basis. A loss from one activity cannot be used to offset income from another. Committee Report on P.L. 99-514. The loss must be carried forward to offset future income from that activity. The loss also may be used upon a disposition of the activity.

The amount entered on line 14m (line 14n for the 1998 tax year) is the difference between the amount that would be reported for the activity on Schedules E or F, or on Form 4835, *Farm Rental Income and Expenses* for the AMT and the regular tax amount. If (1) the AMT loss is more than the regular tax loss, (2) the AMT gain is less than the regular tax gain, or (3) there is an AMT loss and a regular tax gain, the adjustment is entered as a negative amount.

EXAMPLE 25: Drew has a tax shelter farm loss for regular tax purposes of $10,000 in 1993. For AMT purposes, the amount of the loss is $ 5,000. The amount deductible for AMT purposes is $0. The suspended loss for AMT purposes is $5,000. This loss is carried forward until the farm interest is sold or generates income. Drew puts $10,000 on line 14m.

Audit Technique

If the taxpayer is involved in any farming activities, carefully determine if these activities are part of a tax shelter. Each farm activity should be considered independently, as losses from each activity are offset only against income from the same activity.

Line 14m, Section 1202 Exclusion (For Tax Year 1998)

Effective for tax years ending after May 6, 1997, taxpayers who claim the exclusion under IRC section 1202 for gain on qualified small business stock held more than five years must include 42 percent of the exclusion amount, as shown on Schedule D, *Capital Gains and Losses,* as a tax preference on line 14m of Form 6251. The amount is entered as a positive amount. IRC section 57(a)(7).

Line 14n, Related Adjustments (For Tax Years 1993–1997; Line 14o For Tax Year 1998)

If an adjustment is made for items on line 7 (investment interest), lines 8 through 11 (post-1986 depreciation, adjusted gains or losses, incentive stock options and passive activities) or lines 14b through 14m for years 1993 through 1997, or lines 14a through 14n for 1998, an adjustment may have to be made regarding any item of income or deduction based on a limit of income other than AGI or modified AGI. Examples of these items include IRC section 179 deduction, expenses for business or rental use of the home, conservation expenses, taxable IRA (Individual Retirement Account) distributions, self-employed health insurance, Keogh or SEP (Simplified Employee Pension) deductions, and IRA deductions. The difference between the AMT and regular tax amount will result in the adjustment figure. Treas. Reg. section 1.55-1(a),-1(b).

Audit Technique

Examine tax return to determine if there are deductions subject to income limitations other than AGI. If any exist, recompute income limitations based on the AMT income amounts.

Line 15, Total Adjustments and Preferences

This line is an aggregate of all adjustments and preference items.

Alternative Minimum Taxable Income

Line 16, Taxable Income Before Personal Exemptions

The amount listed on the form will be the taxable income of the taxpayer figured without the personal exemption amounts. Personal exemptions are adjustments for AMT purposes. Instead of listing the personal exemptions separately as an adjustment on Form 6251, the form lists income before the deduction.

Line 17, Net Operating Loss (NOL) Deduction

Since line 16 lists the total of all income/loss for the year less itemized deductions, this amount includes any NOL taken on line 21 of Form 1040. Because the NOL will be recomputed for AMT purposes (see below in regard to line 20, line 22 in 1993), Form 1040 NOL will be added back and the AMTNOL deduction will be computed on line 20.

Line 18, Phased-out Itemized Deductions

IRC section 68 provides for an overall limitation on itemized deductions. This limitation is for taxpayers whose AGI exceeds a threshold amount (base amount of $100,000 (or $50,000 for taxpayers married filing separately), adjusted for inflation). Itemized deductions are reduced by the lesser of 3 percent of the excess of AGI over the threshold amount or 80 percent of the amount of the itemized deductions otherwise allowable for such taxable year. For 1993, the threshold amount for a taxpayer filing as single is $108,450 and for 1994 the threshold amount is $111,800. This limitation does not exist for AMT purposes. Thus, an additional deduction is allowed for this amount for AMT purposes and is entered on line 18 as a negative amount.

EXAMPLE 26: Tom's itemized deductions are reduced by $2,500 due to IRC section 68 limitation. Since this limitation does not apply for AMT purposes, Tom should put negative $2,500 on line 18.

Line 19, Sum of Lines 15 through 18

This is a sum of lines 15 (all adjustments and preference items), line 16 (taxable income before personal exemptions), line 17 (NOL as claimed on the tax return), and line 18 (additional deduction allowed for itemized deductions when the taxpayers income exceeds specific limitations). The sum of these lines is the Alternative Minimum Taxable Income before the AMTNOL deduction.

Line 20, Alternative Tax Net Operating Loss (AMTNOL) Deduction

For regular tax purposes a taxpayer will have NOL when his or her business loss/deductions exceeds his or her gross income. The initial loss year is termed the "loss year" per IRC section 172(c). This loss must then be modified to arrive at the deductible NOL.

Note that the 1996 Act adjusted this for the repealed special energy credit deduction and clarified the interaction of the energy deduction with other AMT rules, effective for tax years beginning after December 31, 1990.

These modifications include:

(a) A taxpayer is not allowed NOL deduction (IRC section 172(d)(1));

(b) Capital losses cannot exceed capital gains based on IRC section 172(d)(2);

(c) Personal Exemptions are not allowed based on IRC section 172(d)(3); and

(d) Nonbusiness expense deductions may not exceed non-business income under IRC section 172(d)(4).

In general, IRC section 172(b)(1)(A)(i) allows a NOL carry back to 3 years before the loss year (2 years for tax years beginning after August 5, 1997). A carryover of any unabsorbed NOL is allowed to any of the subsequent 15 taxable years based on IRC section 172(b)(1)(A)(ii) except for the limited exceptions of paragraphs (B) and (E) which involve real estate investment trusts and corporate equity reduction for interest losses. IRC section 172(b)(2) requires a taxpayer to carry back NOL to the earliest year possible unless an election under IRC section 172(b)(3) has been made to forego the carryback period. The election to relinquish the carryback of regular tax NOL cannot be amended and, when made, is considered to be made for AMT purposes also. If NOLs are available for carrybacks from several years, the earliest NOL must be absorbed first according to Treas. Reg. section 1.172-4(a)(3).

The taxpayer must carry back a NOL to the earliest year and then recompute the unabsorbed NOL under IRC section 172(d). After the NOL is taken into consideration, the tax liability of the earliest year is recomputed. A taxpayer should adjust any reported deductions with AGI limitations due to the NOL's reduction in reported AGI. Regular tax provisions in effect for the earliest carryback year to recompute a carryback year's tax liability are followed rather than the law in the loss year where the NOL originates. IRC section 172(e).

If a taxpayer's NOL is not fully absorbed in the earliest carryback year, the remaining NOL is carried to each subsequent year in succession. Each of the carry back/carryover years, when a portion or all of the NOL is absorbed, is defined as an "intervening year."

NOLS for AMT Purposes

The AMTNOL deduction is defined in IRC section 56(d). It is computed the same as the NOL for regular tax purposes with two modifications. IRC section 56(d)(1)(B). The loss is computed by adjusting the taxable income per the adjustment amounts of IRC section 56 and IRC section 58 and reduced by the sum of tax preference items per IRC section 57. IRC section 56(d)(2)(A). However, any item of tax preference will be taken into consideration only to the extent that the item increased the amount of the NOL for the taxable year under IRC section 172(c). IRC section 56(d)(2).

EXAMPLE 27: Gary has $700,000 of gross income and $1,000,000 in deductions for 1993. The deductions include $100,000 of depreciation. Depreciation for AMT purposes is $60,000, resulting in an AMT adjustment of $40,000. Gary's AMTNOL is computed as follows:

Gross Income	$700,000
Less: Deductions	($1,000,000)

Regular Tax NOL	($300,000)
Plus: AMT depreciation Adjustment	$40,000

AMT NOL	($260,000)
	========

EXAMPLE 28: Assume the same facts as Example 27, except that Gary also had tax preference items of $225,000, all of which were included as deductions for regular tax purposes. Gary's NOL for 1993 would be computed as shown.

Gross Income	$700,000
Less: Deductions	($1,000,000)

Regular Tax NOL	($300,000)
Plus: AMT depreciation Adjustment	$ 40,000

	($260,000)
Plus: Preference Items	$225,000

AMTNOL	($ 35,000)
	=========

Be alert to the rare circumstances where the taxpayer may not have an NOL for regular tax purposes, but may have an NOL for AMT purposes. Thus, the computation should begin with the taxpayer's regular taxable income adjusted for AMT adjustment and preference items as shown above.

EXAMPLE 29: Bob has gross income of $36,000, and his depreciation for regular tax purposes is $20,000. His AMT depreciation is $40,000. For regular tax purposes no NOL exists since Bob has taxable income of $16,000. For AMT purposes he will have NOL of ($ 4,000). Thus, the AMTNOL should not be computed as the difference between the regular tax NOL ($ -0-) in this case and the AMT adjustment of $20,000. Rather, taxable income or loss must be recomputed.

For AMT purposes the taxpayer must follow the carryback/carryover treatment of the regular NOL. If a taxpayer elects to forego the carryback of an NOL under IRC section 172(b)(3) for regular tax purposes, the taxpayer must also forego the carryback of the AMTNOL for AMT purposes. When carrying back/forward the AMTNOL, the AMTNOL is absorbed in the carryback or carryover years even if the taxpayer was not liable for AMT in those years.

EXAMPLE 30: Mark incurs an AMTNOL of $16,000 in 1994 and does not elect to forego the carryback period. In 1991, Mark had AMTI of $20,000 but was not liable for AMT. The $16,000 AMTNOL will be carriedback to

1991 and be absorbed by the $20,000 of AMTI. Mark will, therefore, not benefit from the carryback of the AMTNOL.

The AMTNOL deduction is limited to 90 percent of AMTI determined without regard to the AMTNOL deduction. This rule insures that taxpayers will not wipe out their AMT liability with the NOL deduction. IRC section 56(d)(1)(A).

EXAMPLE 31: Jed and Wilma file a joint return and have an AMTNOL in 1992 of $425,000. Their AMT income in 1989 was $100,000. Because the AMTNOL deduction is limited to 90 percent of AMTI, they are allowed to offset only $90,000 ($100,000 x 90 percent) of their 1989 AMT income. The remaining AMTNOL of $335,000 can be carried forward to 1990 and subsequent years.

Once the IRC section 56(d)(1)(A) 90-percent limitation is applied, a taxpayer may not use other AMTNOLs to offset the remaining 10 percent of AMT income.

Line 21, Alternative Minimum Taxable Income

This is the total of taxable income per the tax return adjusted for the adjustments, preference items and AMTNOL.

Exemption Amount and AMT

Line 22, Exemption Amount

The next step in the process is for taxpayers to determine their AMT exemption amount. This amount is based on the taxpayers' filing status and is phased-out at certain dollar limitations. The taxpayers' AMT exemption is reduced by $1 for every $4 (25 percent) in excess of the amount designated in IRC section 55(d)(3). IRC section 55(d)(1) lists the exemption amount. The following chart summarizes the exemption amounts and the exemption phase-out amounts.

	AMITI Exemption	Phase-out Begins at AMTI	Phase-out Ends at AMTI
Married Filing Jointly/ Qualifying Surviving Spouse	$45,000	$150,000	$330,000
Single/ Head of Household	$33,750	$112,500	$247,500
Married Filing Separately	$ 22,500	$75,000	$165,000

IRC section 55(d)(3) provides a special phase-out for taxpayers who are married filing separately. A married taxpayer filing separately must increase his or her AMT taxable income, before the AMT exemption, by the lesser of (a) twenty-five percent of the excess of his or her AMT income over $165,000 (the phase-out of the married filing separately exemption shown in the above chart) or (b) $22,500. This provision was enacted to prevent married taxpayers from filing separately to avoid the phase-out of the married filing jointly exemption when one spouse had income less than the $75,000 phase-out level for a married filing separately return.

EXAMPLE 32: Joe and Ann file jointly and have AMTI of $200,000 for the tax year 1994. Since Joe and Ann's income exceeds the phase-out amount, their exemption amount will be reduced as follows:

AMTI	$200,000
Less:(AMT Exemption Amount for married filing jointly)	($150,000)

Difference	$50,000
Multiplied by 25%	25%

Exemption Reduction Amount	$12,500
	========
Exemption Amount	$45,000
Reduction Amount	($12,500)

Allowed Exemption Amount	$32,500

Line 23, Line 21 Minus Line 22

This is the AMTI less the taxpayer's exemption amount. The result is the amount that the AMT is calculated on.

EXAMPLE 33: In Example 32, Joe and Ann's AMTI of $200,000 less the exemption amount of $32,500 equals $167,500. This amount would be reported on line 23.

Line 24, Calculation of the Actual AMT

IRC section 55(b)(1)(A) lists the actual rates for AMT. The tax is calculated at the rate of 26 percent of the amount which does not exceed $175,000 and 28 percent of the amount which exceeds $175,000. IRC section 55(b)(3). For taxable years ending after May 6, 1997, the amount determined under section 55(b)(1)(A)(I) cannot exceed certain amounts for noncorporate taxpayers because of the maximum rate on net capital gain for those taxpayers.

EXAMPLE 34: Since Joe and Ann's income is under $175,000, the $167,500 will be taxed at the 26 percent rate. If Joe and Ann's AMTI less exemption amount was $225,000, their tentative minimum tax (before calculating the AMT foreign tax credit) would be $59,500. This amount can be computed one of two ways.

$175,000 x 26% =	$ 45,500
($225,000-$175,000) x 28% =	$ 14,000

	$ 59,500
	=======
OR	
$225,000 x 28% =	$ 63,000
Less:$175,000 x 2% =	($ 3,500)

	$ 59,500
	=========

Line 25, Alternative Minimum Tax Foreign Tax Credit (AMTFTC)

Individual citizens, resident aliens and domestic corporations are taxed on their worldwide income. This income may be taxed at both the source country of the income and in the United States. IRC section 164(a)(1). Taxpayers are allowed a foreign tax credit for income which is taxed in both the country of source and in the United States. This credit is a dollar for dollar credit against United States income tax.

IRC sections 901-908 and 960 describe in detail the tax laws surrounding the foreign tax credit. This text will be limited to the general rules and the AMT consequences. The premise behind the FTC is to prevent the income from being taxed in both the country of source and the United States and not to reduce the U.S. tax on the income earned within the United States. IRC section 904 imposes a limit on the foreign tax credit so that the credit does not exceed the U.S. tax attributable to the foreign income. The following formula is used.

$$\frac{\text{Foreign Source Taxable Income}}{\text{Worldwide Taxable Income}} \times \text{Tentative U.S. Tax}$$

Any credit not allowed because of the limitation is carried back 2 years and forward 5 years.

To calculate the FTC for AMT purposes, tentative AMT is used. This is because tentative U.S. tax and foreign source taxable income and worldwide taxable income must be calculated, by applying all AMT adjustment items and preference items per IRC sections 56, 57, and 58. Adjusting for the adjustment and preference items may provide for a different ratio of foreign source taxable income to worldwide taxable income, thus resulting in a different amount of foreign tax credit being allowed. The credit carryback of 2 years and carryover of 5 years is also allowed for AMT purposes. This is another example of why it is important for the taxpayer to keep a separate set of books for AMT purposes.

IRC section 59(a)(2) provides a limitation on the amount of FTC that may be used in a year. Under IRC section 59(a)(2), FTC can be used only to the extent tentative minimum tax (computed without regard to the FTC) exceeds 10 percent of tentative minimum tax (computed without regard to the FTC and the AMTNOL deduction).

EXAMPLE 35: Beth has $400,000 in AMTI for 1993, which includes an AMTNOL deduction of $100,000. Beth's FTC limitation is computed as follows: tentative minimum tax (computed without regard to the FTC) is $108,500 ($400,000 AMTI multiplied by the applicable AMT rate). Ten percent of the tentative minimum tax (computed without regard to the AMTNOL deduction and the FTC) is $13,650. Beth's FTC may not reduce tentative minimum tax below $13,650. Thus, Beth may use only $94,850 ($108,500 minus $13,650) of FTC in 1993.

In the previous discussion of NOLs for AMT purposes, it was noted that the AMTNOL deduction is limited to 90 percent of AMTI determined without regard to the NOL deduction. Thus, if a taxpayer has both an AMTNOL deduction and an AMTFTC, the NOL deduction is applied first. If the AMTNOL deduction reduces AMTI by 90 percent, the taxpayer will not be allowed any AMTFTC.

EXAMPLE 36: In 1993, Jack has $500,000 of AMTI (without regard to the AMTNOL deduction) and an AMTNOL carryover to 1993 of $750,000. Jack's

AMTNOL deduction is limited to $450,000, which is 90 percent of AMTI without regard to the AMTNOL deduction. Jack's FTC limitation is computed as follows: tentative minimum tax (computed without regard to the FTC) is $4,225 ($50,000 AMTI - $33,750 exemption, x 26 percent). Ten percent of tentative minimum tax (computed without regard to the AMTNOL deduction and the FTC) is $13,650. Thus, Jack may not use any FTC in 1993 because 10 percent of his tentative minimum tax (computed without the AMTNOL deduction and the FTC) exceeds his tentative minimum tax (computed without the FTC).

Note that any FTC not allowed as a result of the IRC section 904 limitation or the IRC section 59(a) limitation may be carried to other tax years in accordance with the regular tax FTC rules. Those same limitations must be applied for each year to which the FTC is carried.

Line 26, Tentative Minimum Tax

This is the result of the AMTI, multiplied by the applicable AMT tax rate, and then reduced by the foreign tax credit.

Line 27

On line 27, taxpayers enter an amount equal to their "regular tax liability" minus any foreign tax credit on Form 1040. Depending on the tax year, the foreign tax credit amount appears on Form 1040 as follows:

Tax Year(s)	Line # on Form 1040
1993-1995 and 1997	43
1996	41
1998	46

"Regular tax" is defined in IRC section 26(b). Depending on the tax year, the following line(s) on Form 1040 should be used to arrive at "regular tax liability":

Tax Year(s)	Line # on Form 1040
1993-1995	Line 38 +any amount from Form 4970, *Tax Accumulation Distribution of Trusts* included in line 39.
1996	Line 38
1997	Line 39
1998	Line 40

Per IRC sections 26(b) and 55(c)(1), the following taxes are disregarded when arriving at "regular" tax.

--IRC sections 42(j) and (k), 49(b) and 50(a) relating to increases in tax;

--IRC section 55 relating to minimum tax;

--IRC sections 72(m)(5)(B),(q)(t) and (v) relating to additional taxes on certain distributions;

--IRC section 143(m) relating to recapture of proration of federal subsidy from use of mortgage bonds and mortgage credit certificates;

--IRC section 402(d) relating to the tax on lump sum distributions eliminated for tax years beginning after December 31, 1999;

--IRC sections 453(l)(3) and 453A(c) relating to interest on certain deferred tax liabilities;

--IRC section 531 relating to accumulated earnings tax;

--IRC section 541 relating to personal holding company;

--IRC sections 860E(e) relating to taxes on transfers of residual interest to certain organizations;

--IRC sections 871(a) and 881 relating to certain income of nonresident aliens and foreign corporations;

--IRC sections 884 relating to branch profit taxes.

--IRC section 1351(d)(1) relating to recoveries of foreign expropriation losses;

--IRC section 1374 relating to tax on certain built-in gains of S-Corporations;

--IRC section 1375 relating to tax imposed when passive investment income of S Corporation having subchapter C earnings and profits exceeds 25 percent of gross receipts;

--IRC section 7518(g)(6)(A) relating to nonqualified withdrawals from capital construction funds taxed at highest marginal rate;

For tax years beginning after December 31, 1997, the following taxes are also disregarded when arriving at "regular tax."

--IRC section 59A relating to environmental tax;

--IRC section 220(f)(4) relating to additional tax on medical savings account distributions not used for qualified medical expenses;

--IRC section 530(d)(3) relating to additional tax on certain distributions from individual retirement accounts; and

--IRC section 860K relating to treatment of transfers of high-yield interest to disqualified holders.

Line 28, Alternative Minimum Tax

Alternative minimum tax is the amount by which the tentative minimum tax exceeds the amount of the regular tax. If the tentative minimum tax exceeds the regular tax, the taxpayer will pay an amount equal to the entire tentative minimum tax. No credits (other than FTC) will be allowed to offset the amount of regular tax.

EXAMPLE 37: Cheryl has a regular tax liability for 1994 of $200,000. Her tentative minimum tax (ignoring the AMTFTC) for the year is $250,000. Her alternative minimum tax is $50,000. She will not be able to use nonrefundable tax credits to reduce the $200,000 of regular tax. The only credit available to offset the $50,000 in alternative minimum tax is the AMTFTC.

If the regular tax (reduced by FTC) is greater than the tentative minimum tax, the taxpayer will not be liable for AMT. However, nonrefundable credits are allowed only up to the amount that the regular tax exceeds the tentative minimum tax. IRC section 55(c)(1).

The nonrefundable credits are allowed against the regular tax in the following order:

1. IRC sections 21 (Dependent Care Credit), 22 (Credit for the Elderly) and 25 (Mortgage Interest Credit)

2. IRC section 27 (Foreign Tax Credit)

3. IRC section 28 (Clinical Testing Credit)(redesignated in 1997, as IRC section 45C)

4. IRC section 29 (Credit for Producing Fuel from a Nonconventional Source)

5. IRC section 38 (General Business Credits)

6. IRC section 53 (Credit for Prior Year Minimum Tax Liability).

Any unabsorbed dependent care and credit for the elderly is lost by the taxpayer. Any mortgage interest credit unused will be allowed to be carried forward for 3 years.

After the absorption of the IRC sections 21, 22 and 25 credits, the FTC is allowed against both the regular and tentative minimum tax.

The IRC section 28 clinical testing credit is allowed. Next, any unused remaining credit is lost. (But see, IRC section 53(d)(1)(B)(iv)(II).)

The IRC section 29 credit for producing fuel from a nonconventional source is the next credit allowed. Any credit not allowed also will be permanently lost. (But see IRC section 53(d)(1)(B)(iv)(II).)

The final credits allowed against the liability are the general business credits listed under IRC section 38(b). The more common credits include the investment tax credit (composed of the rehabilitation credit, energy credit and the reforestation credit), the targeted jobs credit, the alcohol fuel credit, the research credit and various other credits listed in IRC section 38(b).

Per IRC section 38(c)(1), the credit allowed for this section shall not exceed the excess of the taxpayer's net income tax over the greater of (1) the tentative minimum tax for the taxable year, or (2) 25 percent of the taxpayer's net regular tax liability as it exceeds $25,000. "Net income tax" means the sum of the regular tax liability plus the AMT under IRC section 55, less the previously discussed credits. IRC section 38(c). "Net regular tax liability" is defined as regular tax reduced by all the credits previously discussed (IRC sections 21, 22, 25, 27, 28, and 29). The business credits not allowed due to this limitation will be allowed to be carried back 3 years and forward 15 years.

EXAMPLE 38: Bryan has a regular tax liability for 1994 of $150,000. His tentative minimum tax (before the AMTFTC) for the year is $100,000. Therefore, Bryan will not be subject to any alternative minimum tax. The maximum credits Bryan can claim against his regular tax liability is, however, limited to the amount that the regular tax exceeds his tentative minimum tax. The maximum credits (excluding the AMTFTC) that Bryan can claim is $50,000. The remaining tentative minimum tax can be offset only by the AMTFTC

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Chapter 3
Other Provisions that Affect AMT

Kiddie Tax

Congress was concerned that some higher income individuals may have been transferring earnings to their children so that the earnings would be taxed at a lower rate. The TRA of 1986 offered a remedy to this potential inequity. Under IRC section 1(g), a child may be subject to the kiddie tax if he or she is under the age of 14, has unearned income, and at least one parent is alive at the close of the tax year. Generally, the kiddie tax taxes at the parent's tax rate the unearned income in excess of $1,200 for tax years 1993 and 1994, $1,300 for tax years 1995 through 1997, and $700 for tax year 1998.

Children will also be subject to the AMT rules of IRC section 53 through IRC section 59. Under the AMT rules, children are not allowed the normal $30,000 AMT exemption for single individuals, but are allowed an exemption for AMT purposes of $1,000 (or if greater, their share of the "unused parental AMT exemption") plus earned income.

IRC section 59(j) was enacted for tax years beginning after 1988. The Form 6251 worksheet (Limit on Alternative Minimum Tax for Children Under the Age of 14) can be used to calculate the AMT kiddie tax for a child. The first step, in computing the AMT kiddie tax, is to compute the child's AMT in the usual manner except that the AMT exemption is equal to earned income plus $1,000 under IRC section 59(j)(1).

Next, the child's AMT cannot exceed the "allocable parental minimum tax" based on IRC section 59(j)(2)(A). This allocable parental minimum tax limitation was repealed for tax years beginning after December 31, 1997. The allocable parental minimum tax is first determined by recomputing the parent's AMT as if the parent's tentative minimum tax was increased by the total of all the children's tentative AMT's. In a similar manner, the parent's regular tax is increased by the regular taxes of all the children. The difference between the parent's total AMT and total regular taxes is subtracted and the difference is allocated among the children based on the regular tax rules of IRC section 1(g)(3)(B).

Note that for tax years beginning after December 31, 1997, IRC section 59(j)(i) provides that the IRC section 55 exemption amount for children subject to IRC section 1(g) is capped at the child's earned income plus $5,000 adjusted for inflation.

Note also that for tax years beginning after December 31, 1997, the limit on the standard deduction is the greater of $500 or earned income + $250. IRC section 63(c)(5)(B).

EXAMPLE 1: Gary, a single individual, has two children, Lloyd, age 13 and Patricia, age 10. For 1994, for regular tax purposes, Gary is in the 28-percent tax bracket. He has a regular tax liability of $48,000 and a tentative minimum tax of $65,000.

Lloyd has earned income of $2,500 and unearned interest income of $7,000. In addition, he has $12,000 interest from specified private activity bonds.

Patricia has earned income of $500 and unearned interest income of $5,000. In addition, she also has $10,000 interest from specified private activity bonds.

Lloyd's regular gross income is $9,500 and his regular taxable income is $7,000 ($9,500 - $2,500 standard deduction). Lloyd's regular tax is $1,830 ($ 6,000 x 28% at parent's rate) + ($ 1,000 x 15% child's rate based on IRS tables).

Lloyd's 1994 AMT computation is calculated as follows:

Regular taxable income			$ 7,000
Standard Deduction			$ 2,500
Preference for interest on Specified Private Activity Bonds			$12,000

AMT Income			$21,500
Less: Exemption Amount			
Earned Income	$2,500		
$1,000 allowance	$1,000		($ 3,500)

AMT income after exemption		$17,000	
Tentative Minimum Tax			
($17,000 x 26%)			$ 4,420
Less: Regular Tax			$ 1,830

AMT			$ 2,590
			======

EXAMPLE 1, CONT.: Patricia's regular gross income is $5,500 and her taxable income is $5,000 ($5,500 - $500 standard deduction). Her regular tax will be $1,270, computed as follows: $1,120 ($4,000 x 28% parent's rate) + $150 ($ 1,000 x 15% child's rate). Patricia's 1994 AMT is computed as follows:

Regular Taxable Income		$ 5,000
Standard Deduction		$ 500
Preference for interest on specified private activity bond		$10,000

AMT Income		$15,500
Less: AMT Exemption		
Earned Income	$ 500	
$1,000 Allowance	$1,000	($ 1,500)

AMT Income after Exemption		$14,000
Tentative minimum tax ($14,000 x 26%)		$3,640
Less: Regular Tax		($1,270)

AMT		$ 2,370
		=======

The allocable parental AMT for 1994 will be computed as follows:

Gary's tentative minimum tax	$65,000
Lloyd's tentative minimum tax	$ 4,420
Patricia's tentative minimum tax	$ 3,640

Augmented tentative minimum tax	$76,060
Gary's regular tax	$48,000
Lloyd's regular tax	$ 1,830
Patricia's regular tax	$ 2,370

	($52,200)

Gary's augmented AMT	$23,860
Less: Gary's actual AMT	($17,000)

Allocable parental AMT	$ 6,860
	=======

This allocable parental AMT must be allocated among the children based on each child's AMT:

EXAMPLE 1, CONT.:		
	Lloyd's AMT	$ 2,590
	Patricia's AMT	$ 2,370

	Children's Total AMT	$ 4,960
	Lloyd's percentage of AMT ($2,590 / $4,960)	52.22%
	Patricia's percentage of AMT ($2,370 / $4,960)	47.78%
	Lloyd's share of allocable parental minimum tax (.5222 x $6,860)	$ 3,582
	Patricia's share of allocable parental minimum tax (.4778 x $6,860)	$ 3,278

In the above example, a reduction is not needed because the allocable parental AMT limitation exceeds each child's tentative AMT. However, let's change the facts in the above example to Gary's tentative minimum tax being $46,000. The example would then work as shown on the next page:

EXAMPLE 1, CONT.: The allocable parental AMT will be computed as follows:

Gary’s tentative minimum tax	$ 4,600
Lloyd's tentative minimum tax	$ 4,420
Patricia's tentative minimum tax	$ 3,640

Gary's augmented tentative minimum tax	$54,060
Gary's regular tax	$48,000
Lloyd's regular tax	$ 1,830
Patricia's regular tax	$ 2,370

	($52,200)

Gary's augmented AMT	$ 1,860
Less: Gary's actual AMT	$ -0-

Allocable parental AMT	$ 1,860

This allocable parental AMT must be allocated among the children based on each child's AMT:

Lloyd's AMT	$ 2,590
Patricia's AMT	$ 2,370

Children's Total AMT	$ 4,960
	======
Lloyd's percentage of AMT ($2,590 / $4,960)	52.22%
Patricia's percentage of AMT ($2,370 / $4,960)	47.78%
Lloyd's share of allocable parental minimum tax (.5222 x $1,860)	$ 971
Patricia's share of allocable parental minimum tax (.4778 x $1,860)	$ 889

This example shows that when the allocable parental AMT limitation is less than the child’s AMT, the lesser of the two amounts will be the child’s AMT. If the allowable parental

AMT limitation is greater than the child's AMT, no adjustment or reduction will be made to the child's AMT.

Partnership and S-Corporation Flow-Throughs

AMT pass-through items are required to be reported on each shareholder's or partner's tax return. The allocation for these items should follow the regular tax allocation rules.

EXAMPLE 2: An S-Corporation is made up of two individuals, Sally and George, each 50-percent shareholders. Each shareholder would report 50-percent of the income or loss (disregarding the basis, passive and at-risk rules) on their individual returns. If the S- Corporation has AMT tax preference items or adjustments, these will be computed at the S-Corporation level and divided by percentage of ownership between the shareholders. If the S-Corporation had regular depreciation of $2,000 and AMT depreciation of $1,000, of the $1,000 AMT adjustment, $500 would be allocable to each 50-percent partner. This figure is then reported on the depreciation adjustment line (line 8) of Form 6251 and is added with the shareholder's other AMT adjustment and preference items.

At-Risk Rules and Basis Limitations

Per IRC section 59(h), the at-risk rules of IRC section 465 and basis limitation rules of IRC section 704(d) and IRC section 1366(d) require a separate computation of allowable deductions.

EXAMPLE 3: Wendy has a property for which she is at risk for $1,000. For regular tax purposes, if her deductions exceed the $1,000 she will not be allowed to take these amounts and will have a suspended loss. If, however, for AMT purposes the deductions are less than $1,000 then she will have less unused at-risk for AMT purposes.

Therefore, it is important to keep separate records regarding the at-risk amount (as well as any basis limitations) for regular tax purposes and for AMT purposes.

Estimated Tax Payments

For purposes of making estimated tax payments per IRC section 6654, the taxpayer's AMT liability must be considered and included in the taxpayer's computations regarding estimated payments.

Short Tax Years

AMT computed for a short taxable year requires a taxpayer to annualize AMT taxable income (multiply by 12 and divide by number of months in the short year). Then multiply the resulting tentative AMT by a fraction which is the number of months in the short year divided by 12. IRC section 443(d).

Restricted Consents and AMT

If a restricted consent to extend the statute of limitations on assessment is secured, insure that any potential changes to AMT are included in the restricted consent language. If the restricted consent language as provided in the IRM is modified, approval through the Quality Measurement Staff is required. The Tax Court held in *Bauer v. Commissioner*, T.C. Memo. 1992-257, that the Service was prohibited from asserting AMT on adjustments from partnership flow-through items because such corrections were not consequential changes included in the language of the restricted consent. The AMT adjustments were therefore barred by the statute of limitations.

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Chapter 4
Minimum Tax Credit

Minimum Tax Credit/General Rules

The Minimum Tax Credit (MTC) is the difference between the AMT computed "with exclusion and deferral items" in the usual manner and the AMT computed using only exclusion items or "without deferral preferences."The MTC is carried forward (no carrybacks are allowed) to the next year and can reduce only the excess of the regular tax (reduced by all other nonrefundable credits) over the tentative minimum tax in a subsequent year. If all of the credit is not used in the subsequent year, it is aggregated in future years and becomes part of the MTC for that year. This credit is carried forward indefinitely until used in full.

The MTC is computed only on deferral items. IRC section 53(d)(1)(B)(ii) lists the "exclusion" amounts which are not allowed in the computation of MTC. These exclusion items include adjustment for miscellaneous itemized deductions and certain taxes (IRC section 56(b)(1)), depletion preference (IRC section 57(a)(1)), tax-exempt interest on private activity bonds (IRC section 57(a)(5)), and the exclusion for gains on sale of certain small business stock (IRC section 57(a)(7)). All other AMT adjustments and preference items are deferral items and are included in the computation of the MTC.

EXAMPLE 1: Don and Tanya file a married filing joint return for 1993. They have taxable income of $80,000 and a regular tax liability of $17,610. They have deferral items of $45,000 and exclusion items of $20,000. The MTC carryforward to 1994 is computed as follows.

AMT with both deferral items and exclusion items.

Taxable Income	$80,000
Deferral Items	$45,000
Exclusion Items	$20,000
Exemptions	($ 45,000)

	$100,000
	@ 26%

Tentative AMT	$ 26,000
Regular Tax	
	($17,610)

Net Minimum Tax	$ 8,390
	=======

AMT with only exclusion items or "without deferral items"

Taxable Income	$80,000
Exclusion Items	$20,000
Exemption	($45,000)

	$ 55,000
	@26%

Tentative AMT	$ 14,300
Regular Tax	($17,610)

Net Minimum Tax	$ -0-
	=======

MTC is to be carried over to 1994 is $8,390. The amount of this credit to be used in 1994 is limited to the amount that the taxpayers' regular tax exceeds their tentative minimum tax for 1994.

EXAMPLE 2: Assume that in 1994 Don and Tanya have a regular tax liability of $25,000 and a minimum tax of $20,000. The amount of MTC available for Don and Tanya for 1994 is $5,000, (the difference between the regular tax liability of $25,000 and the tentative minimum tax of $ 20,000). The remaining $3,390 is carried forward and used in future tax years.

In certain circumstances, such as the sale of depreciable property or assets nearing the end of their depreciable life (where the straight-line AMT adjustment exceeds the accelerated method), a negative MTC adjustment may result. The following example illustrates this point.

EXAMPLE 3: Jim and Marsie file a joint tax return for 1993. Their regular taxable income is $90,000. They had deferral items (depreciation) of ($10,000) and exclusion items of $50,000.

AMT with both exclusion and deferral items

Regular Taxable Income	$ 90,000
AMT Deferral Items	($ 10,000)
AMT Exclusion Items	$ 50,000

AMTI with deferrals and exclusions	$130,000
Exemption	($ 45,000)

	$ 85,000
	@26%

Tentative Minimum Tax	$ 22,100
Regular Tax	($ 20,436)
AMT	$ 1,664
	========

AMT using exclusion items only or "without deferral items"

Regular Taxable Income	$ 90,000
AMT Exclusion Items	$ 50,000

AMTI with exclusion items	$140,000
Exemption	($ 45,000)

	$ 95,000
	@26%

Tentative Minimum Tax	$ 24,700
Regular Tax	($ 20,436)

AMT	$ 4,264
	========

Difference between AMT with exclusions and deferrals $1,664 and AMT with exclusion items only $ 4,264 is ($ 2,600). This negative amount will offset prior positive credits generated in the earlier years of the asset's life when the accelerated depreciation exceeds the AMT depreciation.

This computation shows once again the importance of the taxpayer keeping separate books for regular and AMT purposes.

Minimum Tax Credit Net Operating Loss (MTCNOL)

When computing the NOL for MTC purposes (known as MTCNOL), the NOL for the exclusion items only or without deferral items should be computed using only the exclusion items. IRC section 53(d)(1)(B)(i)(II) further states that this amount will not be subject to the ninety percent limitation of tax per IRC section 59(a)(2) (relating to foreign tax credit). If a taxpayer used a carryback of an AMTNOL to reduce a prior year's AMT liability and the prior year's AMT liability generated a MTC which was carried forward and used, the taxpayer will have to recapture the MTC in the year in which it was used.

Minimum Tax Credit and AMT Foreign Tax Credit

As previously discussed under the MTCNOL, the 90-percent limitation of taxable income does not exist when computing the FTC for AMT with exclusion items only. IRC section 53(d)(1)(B)(i)(II).

EXAMPLE 4: If tentative income tax before credits for both AMT with deferrals and exclusions and AMT with exclusions only is $34,000, and the FTC is $40,000, the FTC allowed for AMT with deferrals and exclusions would be limited to 90 percent or $30,600. When computing the FTC for AMT with exclusions only, the 90-percent limitation does not apply. Thus, the full $34,000 can be offset by the FTC. In this example, there would be an MTC of $3,400.

Special Rules Relating to Regular Tax Credits from Nonconventional Fuel Sources, Orphan Drug Credit* and Qualified Electric Vehicle Credit

In the limited circumstances when a taxpayer has a nonconventional fuel credit under IRC section 29, special MTC provisions can apply. For regular tax purposes, such fuel credit

*P.L. 104-188, Sec. 1205(d)(5)(A) deleted reference to Orphan Drug Credit (IRC section 28) from IRC section 53(d)(1)(B)(iii), for amounts paid or incurred in tax years ending after June 30, 1996.

is usually limited to the excess of a taxpayer's regular tax over the tentative minimum tax. If this regular tax limitation causes a taxpayer to lose the benefit of a portion of the fuel credit, the taxpayer is allowed to increase the MTC by the disallowed credit amount. IRC section 53(d)(1)(B)(iii).

For example, a taxpayer who cannot use $5,000 of his nonconventional fuel credit due to the IRC section 29(b)(6)(B) limitation can increase his or her MTC by $5,000. A similar rule for the nonconventional fuel credit is provided for the orphan drug credit and the qualified electric vehicle credit. IRC section 53(d)(1)(B)(iii).

Computing the Minimum Tax Credit

The computation of the MTC is completed by taxpayers on Form 8801, Credit for Prior Year Minimum Tax-Individuals, Estates, and Trusts.

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Chapter 5
Prior Law

The laws covered in the previous sections of this guide are for tax years 1993 through 1998. This portion of the guide on "prior law" will cover primarily tax years 1990, 1991, and 1992. Tax years prior to 1990 should be further researched using the available tax services. This portion of the guide will address only the law that differs from the "current law" discussed previously.

Personal Exemptions

For tax years 1991 through 1993, personal exemptions are adjusted as previously discussed. For tax year 1990, IRC section 1(g) provided an indirect phase-out of personal exemptions and the lower 15-percent rate by increasing the 28-percent rate to 33-percent. Even if a taxpayer's personal exemption is phased-out, an AMT adjustment is still required. Taxpayers cannot claim that no tax benefit was received for their personal exemptions.

Personal Interest

Regular tax law provides that personal interest is not deductible by individual taxpayers based on IRC section 163(h), except for phase-out allowances for 1987 through 1990. IRC section 163(h) defines personal interest as deductible interest other than the following: (1) trade or business interest; (2) investment interest; (3) interest related to passive activity income or loss; (4) qualified residence interest; and (5) deferred interest from special estate tax situations under IRC sections 6163 and 6166.

Examples of personal interest include: credit card interest, auto loan interest, home mortgage interest other than qualified housing interest (such as interest on a third residence) and interest on most tax deficiencies.

The phase-out allowances for 1987 through 1990 discussed above were as follows:

Year	Percent of Interest Allowed
1987	65%
1988	40%
1989	20%
1990	10%

For AMT purposes, no personal interest is allowed. Thus, for the tax years 1987 through 1990, the phase-in percentage allowed will be an adjustment for AMT purposes.

Investment Interest

Investment rules for years prior to 1993 are similar to those of the current year law with the exception of the tax years 1987 through 1990, which allowed a phase-in similar to the personal interest rules. Investment interest for the years 1987 was allowed up to the amount of investment income plus the additional phase-in (the same percentages were allowed as shown above for personal interest) of the lesser of $10,000 or the excess of interest expense over interest income.

For AMT purposes, phase-in of the excess of investment interest expenses over income is not allowed.

EXAMPLE 1: In 1990, Terri has $50,000 of net investment income and $65,000 of investment interest expenses. For regular tax purposes, she will be allowed $51,000 ($50,000 plus 10 percent of the lesser of $10,000 or excess interest of $15,000) of investment interest expense. For AMT purposes, she will be allowed $50,000 of investment interest and a $15,000 carryover of excess interest expense over income. For regular tax purposes, her carryover will be $14,000.

This is another example of the necessity of separate records for regular and AMT purposes.

Passive Activities

The passive activity rules were brought into law under the TRA of 1986. As previously discussed, these rules limit the amount of "passive" losses taxpayers can deduct on their tax returns to the amount of "passive" income reported on the tax return. As with many of the new laws passed under the TRA of 1986, the passive activity law offered a phase-out of the losses disallowed. For tax years 1987 to 1990, losses were allowed up to the amount of income plus a specified percentage of the remaining loss. Each year the percent was reduced. The percentages of additional loss allowed were as follows:

Year	Percent of Interest Allowed
1987	65%
1988	40%
1989	20%
1990	10%

EXAMPLE 2: Carolyn has passive income in 1990 of $10,000. She also has passive losses (not from rental real estate) of $ 15,000. She will be allowed to deduct losses of $10,500 for 1990 ($10,000 up to amount of income plus 10 percent of the remaining $5,000).

For AMT purposes, in addition to the losses being recomputed using all the tax preference items and adjustment items, the additional phase-in loss is not allowed.

EXAMPLE 3: Consider the same facts as Example 2, except that for AMT purposes Carolyn's loss is $13,000. For AMT purposes, her loss will be allowed up to the amount of passive income, and thus she will be able to deduct $10,000 of losses. The additional phase-out loss will not be allowed for AMT purposes.

Charitable Contributions

Under the general rules surrounding charitable contributions, the taxpayer is allowed an itemized deduction for charitable contributions made to qualified organizations. These contributions must be actually paid in the year deducted and must be to a qualified organization as defined in IRC section 170(c). These contributions are further limited. The maximum the taxpayer can deduct as contributions is 50-percent of the taxpayer's contribution base. The contribution base is the AGI computed without regard to any NOLs. The amounts can be limited further based on the type of property contributed and the type of organization to which the property was contributed. There are three limitation categories: the 50-percent limitation, the 30-percent limitation, and the 20- percent limitation.

The 50-percent limitation category is for contributions to organizations listed in IRC section 170(b)(1)(A)(i)-(viii). This includes governmental organizations, churches, schools, hospitals, and certain private operating foundations.

The *30-percent limitation category* includes private foundations listed in IRC section 170(c)(2) that do not qualify under IRC section 170(b)(1)(E) and qualifying organizations listed in IRC section 170(c)(3) through IRC section 170(c)(5). These organizations include the American Legion, Veterans of Foreign Wars, AMVETS, domestic fraternal societies, and nonprofit cemeteries.

The *20-percent limitation category* is applicable to donations of capital gain property (stocks, bonds, etc.) to all qualified organizations other than fifty percent organizations.

Contributions in excess of the limitations are carried over for 5 years and are to be deducted as follows. Treas. Reg. section 1.170A-10(b)(2).

1. Contributions to 50-percent organizations paid in the current year;

2. Carryovers of unused contributions to a 50-percent organization;

3. Contributions to 30-percent organizations paid in the current year;

4. Carryovers of unused contributions to a 30-percent organization;

5. Contributions limited to 20-percent; and

6. Carryover of contributions limited to 20-percent.

There are special rules regarding the deductibility of contributions of appreciated property. If the property is ordinary income property (such as inventory), adjusted basis is used as the amount contributed. This property will fall into the 50-percent limitation or 30-percent limitation depending on the type of organization the property is contributed to.

If the property is capital gain property (items which would result in a long-term capital gain if sold), it is deducted at its fair market value. If the property is donated to a 50-percent organization, it is subject to the 30-percent limitations. If the property is donated to a 30-percent organization, the amount is subject to the 20-percent limitation. An election can be made by the taxpayer to deduct the amount at its adjusted basis; if this is done, the taxpayer can then use the 50-percent limitation. IRC section 170(e)(1)(B) further limits property contributed to the 30-percent limit; or if the gift is of tangible personal property put to a use that is unrelated to the purpose or function upon which the donee's exemption is based, adjusted basis of the property is used rather than its fair market value.

For AMT purposes for years prior to 1993, the AMT preference item existed only for capital gain property contributed and deducted at its fair market value. The adjustment amount is for the difference between the fair market value and the adjusted basis of the property. To further complicate this general rule, the Revenue Reconciliation Act of 1990, provided a special 1-year exemption for gifts of tangible personal property. This exemption was then extended by the Tax Extension Act of 1991 to any contributions of property made before July 1, 1992, in any taxable year beginning in 1992.

Therefore, if taxpayers deduct their contributions at the adjusted basis, there are no AMT implications.

EXAMPLE 4: Wendy makes a gift of capital gain property with an adjusted basis of $40,000 and a fair market value of $60,000. Her AGI is $500,000. If she deducts the gift at its fair market value of $60,000, she will have an AMT preference of $20,000. However, if she elects to deduct the gift at its adjusted basis of $40,000, no AMT preference will be present.

Intangible Drilling Costs (IDC)

The Comprehensive National Energy Act of 1992 repealed the AMT intangible drilling costs preference item for independent oil and gas producers except for large retailers and refiners, such as integrated oil companies. This law was in effect for tax years beginning after December 31, 1992. Thus, for tax years 1992 and prior, all oil and gas producers were required to adjust for AMT as previously discussed. For years beginning after December 31, 1990, and before December 31, 1992, the Energy Preference Deduction is available as discussed below.

Energy Preference Deduction

The Energy Preference Deduction was enacted for AMT purposes and is effective only for tax years beginning after December 31, 1990, and before December 31, 1992. There are no regular tax implications relating to this deduction.

Under IRC section 56(h), taxpayers may be able to deduct a portion of their AMTIDC and depletion preferences through the special energy preference deduction. The special energy deduction is subject to phase-out in a taxable year following a calendar year if the average price of crude oil exceeds $28 a barrel, as adjusted for inflation. The special energy preference deduction was not allowed for an integrated oil company.

The actual computation of the special energy preference deduction involves the following general steps:

1. 75-percent of a taxpayer's IDC preference involving "qualified exploratory costs;"

2. 15-percent of the taxpayer's IDC preference involving other costs; and

3. 50-percent of the taxpayer's "marginal production depletion preference."

The terms "qualified exploratory costs" and "marginal depletion preference" are IRC ‘ definitions limited to the special energy preference deduction. Definitions for the energy preference deduction computation are as follows:

Integrated Oil Company - Any producer of crude oil that does not qualify as an independent producer or royalty owner under the percentage depletion rules because it is either (1) a <u>retailer</u> of oil or natural gas or any oil or natural gas derivative product (defined under IRC section 613A(d)(2) or (2) a <u>refiner</u> of crude oil as defined under IRC section 613A(d)(4)).

Qualified Exploratory Costs - IDCs which involve the drilling of a domestic exploratory oil or gas well (other than a geothermal well) which may be capitalized or expensed based on the taxpayer's election under IRC section 263(c). If taxpayers elect to capitalize their IDCs based on IRC section 59(e), exploratory IDCs would include any related IDC's costs under this election based on the yearly amortization under IRC section 56(h)(6). Exploratory costs are limited to wells located in the United States.

Generally, IDCs for offshore drilling are excluded from the definition of qualified exploratory costs based on IRC section 56(h)(6)(C)(i). Excluded costs include those for construction, purchase, transportation, erection, or installation of an offshore platform. However, the IDCs which are incurred on an offshore platform and involve the first well which penetrates a reservoir are allowed in the computation of the special energy deduction based on IRC section 56(h)(6)(C)(ii). The definition of an offshore platform does not include drilling costs related to mobile drilling rigs or ships.

Exploratory Well - An exploratory well is any of the following oil or gas wells:

1. A well that is completed (or for which drilling operations have ceased) before completion of any other well capable of production in commercial quantities within 1.25 miles;

2. A well that is at least 800 feet deeper than any other completed well capable of production in commercial quantities within 1.25 miles; or

3. A well capable of production in commercial quantities within 1.25 miles, or in a new reservoir (other than a well to produce gas from Devonian shale, coal seams, or a tight formation). IDC's for wells (1) or (2) above could be nonproducing wells, but (3) must be producing.

IRC section 56(h)(6)(B).

Exploratory Well Certification Procedures - Revenue Procedure 92-62 explains the procedures to obtain certification of an exploratory well for the alternative tax energy preference deduction. An operator of an exploratory well is required to obtain a separate certification for each well.

An exploratory well must be certified by the last date (including extensions) for filing the return of the operator for the first taxable year the alternative tax energy preference deduction is reported. However, a taxpayer can still satisfy the engineer certification requirement after this initial "election" period if an engineer's certification is obtained based on the Service's request in a subsequent year. This revenue procedure is effective for returns filed after August 10, 1992.

Intangible drilling cost preference - The IDC preference item for AMT under IRC section 57(a)(2) except for any IDCs attributable to geothermal deposits. IRC section 56(h)(4).

Fraction of IDC Preference Involving Qualified Exploratory Costs - The portion of the taxpayer's IDC preference for AMT purposes can be determined based on the following ratio (IRC section 56(h)(4)(B):

$$\text{AMTIDC Preference} \times \frac{\text{Domestic Qualified Exploratory IDCs}}{\text{Total Domestic IDCs}}$$

Geothermal Deposits - Intangible costs for the drilling of deposits in a geothermal reservoir which consists of natural heat stored in rocks or in a liquid or vapor state according to the percentage depletion definition under IRC section 613(e)(2).

Marginal Production Depletion Preference -The portion of the depletion preference under IRC section 57(a)(1) which is attributable to marginal production as defined under IRC section 613A(c)(6)(D). Marginal production is defined as domestic oil or natural gas which is produced from a property which is a stripper well or is from a property involving the production of heavy oil. IRC section 56(h)(5).

Reduction in special energy deduction by phase-out percentage-(Applicable only to tax year 1991.) There is an overall reduction in the amount of the special energy deduction for any taxable year that begins in the calendar year that immediately follows a calendar year in which the reference price of crude oil exceeds $ 28 per barrel as adjusted for inflation. IRC section 56(h)(2).

An important point for a taxpayer's consideration is the definition of exploratory wells because regulations have not been issued. The issue of when a well is capable of production will most likely be based on engineering certifications already obtained for most oil and gas wells according to IRC section 56(h)(6)(B). A well will apparently not be considered capable of production until it has been completed and a "Christmas tree," storage tank, battery, pipeline, or other mechanism to regulate the flow of oil or gas is installed.

The Conference Agreement Committee Reports for the Omnibus Budget Reconciliation Act of 1990 (P.L. 101-508), H.R. Rep. No. 101-964 p.1129 (1990), supports the inclusion of nonproducing well IDCs in exploratory costs.

EXAMPLE 5: Kathy is an individual who in 1991 has an IDC preference item for AMT purposes of $160,000 with total IDCs of $200,000. Qualified exploratory costs of $70,000 are included in this total. The marginal production preference is $25,000. Her AMT taxable income is $250,000, with no AMTNOL. The deduction is computed as shown below.

Qualified exploratory costs ($70,000 x 75%)	$60,000
Total IDCs less qualified exploratory costs ($200,000 - $ 70,000= $130,000 x 15%)	$19,500
Marginal Production Preference ($25,000 x 50%)	$12,500 -----------
Energy deduction before limitation	$92,000 ======

The energy deduction is not allowed to the extent that it exceeds 40-percent of the AMTI, as determined without regard to the energy deduction itself or the AMTNOL deduction.

Thus, Kathy's deduction is limited to 40-percent of $250,000 or $100,000. Kathy will be allowed the full deduction for 1991. If the deduction is limited, the unused portion of the energy deduction cannot be carried back or forward to another taxable year.
The combination of this deduction and the AMT foreign tax credit cannot reduce more than 90- percent of the taxpayer's AMT tax liability as determined without those items.
The 40-percent limitation is applied before the $28 per barrel of crude oil limitation is applied. Per IRC section 56(h)(2), the $28 per barrel of crude oil works as follows.
Assume that the price per crude oil is $32.

$$\text{Phase-out} = \frac{(\$32 - \$28)}{\$6} = 67\% \text{ or } 2/3$$

Thus, using Example 5 above, Kathy's deduction would be reduced by 2/3 or $61,333 ($92,000 x 2/3). Kathy would be allowed an energy deduction of $30,667.

It is important to remember this deduction applied only to tax years 1991 and 1992.

Long-term Contracts

The long-term contract rules came into effect beginning in tax year 1986. Before that time, the taxpayer could use the percentage of completion method or the completed contract method. Congress felt that too many taxpayers were delaying the reporting of income under the completed contract method. Thus the requirement that all long-term contracts be reported on the percentage of completion method. There was, however, a grandfather clause which allowed taxpayers to report a portion of their income under the percentage of completion method and a percentage on their prior method (completed contract or the less encompassing percentage of completion method). This method was known as the percentage of completion capitalized cost method (PCCM).

From February 28, 1986, until October 13, 1987, taxpayers could report 40-percent under the percentage of completion method and 60-percent under their prior method. From October 14, 1987, until June 20, 1988, taxpayers could report 70-percent under the percentage of completion method and 30-percent under their existing method. From June 21, 1988, until July 10, 1989, taxpayers could report 90-percent of the contracts under the percentage of completion method and 10-percent under their existing method prior to the enactment of IRC section 460. After July 10, 1989, taxpayers must report their contracts using 100-percent percentage of completion. The periods listed above are for the date the contract was entered into. Thus, if a contract was entered into on June 1, 1988, that contract could be reported using 70-percent of completion and 30- percent completed contract. This method would then be used for that contract until completed. Taxpayers were not required to use this method. They could also report all contracts using 100-percent percentage of completion.

For AMT purposes, taxpayers must use 100-percent percentage of completion. Thus, for those taxpayers using the PCCM method, there will be an adjustment for the percentage reported under their prior accounting system. The methods available for computing AMT percentage of completion are discussed in the current years text portion for long-term contracts.

EXAMPLE 6: Shawn is a general contractor reporting his income prior to the TRA of 1986 on the completed contract method. Due to the change in the law, he begins reporting his income using the percentage of completion method. In 1990, he has one contract remaining which was entered into on July 1, 1988. Thus, for regular tax purposes, he will report 90 percent of the contract amount under the percentage of completion and 10 percent under the completed contract. For AMT purposes, he must report the income using 100 percent of the completed contract method. Thus, if under the PCCM method his income is $12,000 and using the PCM method his income is $14,000, he will have a $2,000 positive AMT adjustment.

Research and Experimental

For tax years 1990 and prior, the material participation exception per IRC section 56(b)(2)(D) was not in existence. Thus, even for those investors who materially participated, the AMT adjustment requiring the 10 year amortization would be in effect for tax years 1990 and before.

Depletion Expense

The Comprehensive National Energy Policy Act of 1992 repealed the AMT depletion preference for independent oil and gas producers and royalty owners for tax years beginning after December 31, 1992. Before 1992, the rules as previously discussed were in effect for independent oil and gas producers and royalty owners.

Alternative Tax Net Operating Loss

The 90-percent limitation rule is inapplicable to a carryback before the enactment of the TRA of 1986 (1986 and prior years). The carryback/carryover AMTNOL rules primarily involve post-1986 (1987 and subsequent) taxable years. However, a taxpayer with unused AMTNOLs from years before 1987 and after 1983 can carry the losses over and absorb them in post-TRA of 1986 taxable years. The computation of the AMTNOL in a 1983 through 1986 loss year is based on pre-TRA 1986 law under IRC section 55(d)(2). Carryovers for pre-1987 AMTNOLs are governed by IRC section 56(d)(2)(B). A taxpayer with an unused regular tax NOL from a taxable year beginning before 1983 can carry it forward as an AMTNOL in succession until the loss is fully absorbed.

AMT Exemptions

For tax years 1990, 1991, and 1992, the amount of the exemption is $40,000 for married filing jointly, $20,000 for married filing separately, and $30,000 for single individuals. The thresholds for phase-out of the exemption are the same as those previously discussed. The phase-out for married filing jointly taxpayers begins at $150,000, married filing separately $75,000, and single individuals $112,500. The phase-out itself is also the same as previously discussed ($1 for every $4 over the before mentioned designated phase-out amount).

Percentage Applied When Arriving at Tentative AMT

For tax year 1990, the tentative AMT is arrived at using a percentage of 21-percent. For 1991 and 1992, the percentage is 24-percent.

Minimum Tax Credit

For tax years prior to 1993, the exclusion preference items include the preference for charitable contributions.

Kiddie Tax

The kiddie tax may apply to children under 14 years old for all unearned income in excess of $1,000 for 1990, $1,100 for 1991, and $1,200 for 1992.