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WHERE HAVE ALL THE DEDUCTIONS GONE?

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ABSTRACT: If a married couple filing jointly has income of $100,000 or more, the income tax liability may very well be computed by applying a flat rate. Over the past several years there have been dramatic changes to the Internal Revenue Code. These changes have been made piecemeal to increase deductions and exemption amounts for inflation, and to eliminate the marriage penalty. Long-term capital gain rates have also been reduced. Many expressed concerns that these changes have been adjustments that basically benefit the homeowner and the financial well-to-do. As a counter measure, the Alternative Minimum Tax is in place, so that a minimum tax must be paid, regardless of deductions. This discussion focuses on the regardless. The tax structure for the affected taxpayer will be addressed. Much of the conventional tax structure which was built upon the framework of deductions and exemptions may no longer apply. The affected taxpayer primarily takes a deduction, and pays a flat tax. This may require tax planning to be taken from a different prospective.

INTRODUCTION

The reality of the present tax structure is that many married filing jointly with income of $100,000 or more, and single taxpayers with income of $50,000 or more are taxed at a flat tax rate. This is especially so for taxpayers from high income tax states, such as New York. The likelihood that the flat tax will apply increases if the taxpayers are 1) married, 2) both are wage earners and 3) have children. With the exception of some tax professionals, and some sophisticated taxpayers, the bulk of taxpayers affected are unaware of this tax structure which is growing strong and is taking root. This flat tax is known as the alternative minimum tax (AMT). Little guidance or tax education has been given by the Internal Revenue Service to educate this group on its destined tax structure which includes, (among other items not here discussed) little or no deduction for the items listed below.

1. Medical expenses
2. State and local income taxes
3. Real estate taxes
4. Other taxes
5. Job expenses
6. Most other miscellaneous deductions
7. Personal exemptions
8. The lower rates for dividends and capital gains

Each year the Internal Revenue Service issues to taxpayers the 1040 package, which includes tax forms and instructions. The 2004 package is one hundred and twenty eight pages. Only one page addresses the AMT; it is merely a worksheet to determine if the AMT applies. Upon closer analysis, this limited coverage is quite effective, as the worksheet is a very concise and quite an accurate capsulate presentation of the AMT. It

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is essentially a worksheet that the taxpayer should consider for tax planning and projections. Optimally, it should be reviewed before the tax year has ended to determine if any tax strategies can be undertaken to reduce tax liability. What follows is a hypothetical situation of a married filing jointly couple with four young children. Both parents are working and are college educated, providing well for their children, through home ownership, and the other economic benefits that go along with their economic situation. As a knowledgeable couple, they plan many of their expenditures around the tax laws in effect, to reduce their tax liability. Unfortunately, as the illustration will show, the AMT undermines this tax planning.

The tax structure that many are schooled in is the same tax structure that applied to their parents. However, the actual tax structure may be very different.

Illustration

John and Jane Smith have income for 2004 as follows,
John wages $100,000,
Jane wages of $50,000,
Qualifying dividends of $2,000 at the 15% preferred rate.

Their four children are under the age of seventeen
The following is a list of other pertinent tax information:

1. Medical expenses, including dental totaling $16,000
2. State and Local income taxes $8,000
3. Real Estate Taxes $4,000
4. Home Mortgage Interest Paid $16,000
5. Gifts to Charity $4,000
6. Job Expenses, educational expenditures related to Mrs. Smith's employment $13,040
7. Total exemption 6x $3,100= $18.600
8. Child care expenses for the two children under thirteen years of age is $6,000

Required:
Compute the 2004 tax liability for Mr. And Mrs. Smith consistent with the AMT application.

Total Wages and Dividends	$152,000
Less: Charity Deduction	(4,000)
Less Medical ($16,000-10% of AGI of 152,000)	(800)
Home Interest Expense	(16,000)
Total	$131,200
Less: Exemption Amount:	
Married Filing Jointly for AMT purposes	58,000
Taxable Income	$73,200
Tax Rate	x 26%
Tax Liability before tax credits	$19,032
Less: Child Care Credit $6,000 x 20%	(1,200)
Less: Child Tax Credit ($1,000 x 4 minus $2,100)	(1,900)
Net Tax Liability	$15,932

The 1040/ 2004 for Mr. and Mrs. Smith, line 74, using Turbo Tax calculates the same amount of $15,932.

Technically, the standard procedure, or step one, is to first compute the taxable income following the regular procedure of adjusted gross income, less itemized deductions, less personal exemptions, to arrive at taxable income, and calculate the tax liability using the tax rate schedules, and adding the preferred tax rate for dividends and capital gains.

Step two, is the above presented calculation. The calculation with the highest tax liability is the tax liability for the year, which is the above presented calculation in this case. If the AMT is lower than the conventional tax, it does not apply.
Step one can be a distraction on the way to the final tax since it may not apply as it does with this illustration. The difference between the two taxes is the AMT, which causes confusion, since the regular tax appears to effect the total tax since it is the base amount to which the alternative is add to, However it really is a "working backwards or plug" amount to arrive at the higher tax. This is reflected by its presentation on the 1040 which is given below.

Per the 1040/2004

Line 43) Tax	$15,244
Line 44) Alternative Minimum Tax	3,788
Line 45) Tax before credits	$19,032

In this situation the taxpayers are very preoccupied by many of the deductions that are ignored in the final and actual tax computation.

In this example, the taxes, the dividends, the job expenses, the medical expenses with the exception of $800 of the $16,000, did not affect the final income tax, or the fact that the family had a total of six exemptions. The standard answer to the question of "How can I reduce my taxes?" was "Get married and have children" may not apply today.

Taxpayers, hovering around combined income of $100,000 for married and $50,000 for singles, should determine first if they are an AMT candidate, before the old advice of deferring income and maximizing deductions as the route to tax avoidance is undertaken, since it may not effect the final tax liability. Otherwise, the taxpayer may be totally inefficient in tax planning.

CONCLUSION

Every tax scenario is different and this example includes just a few of the items that affect the AMT. What has been illustrated with this case study is that Mr. and Mrs. Smith are not tax planning efficiently. Many of their deductions reaped them no tax reduction. A different tax strategy should be undertaken by those affected by the AMT. Actually, Mr. and Mrs. Smith could have had higher taxable income (less deductions, more income, or a combination of both), and still have had the same tax. This seems contrary to conventional tax wisdom, however it is factual. It is time for mainstream information about the AMT to be circulated. It has been projected by Urban-Brookings

Tax Policy Center that one-third of all taxpayers, or 94% with income of $100,000 or more will be subjected to the AMT in five years for now, for tax year 2010.

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