AMT vs. NOL: When two worlds collide

Michael L. Garcia
The University of Tampa

ABSTRACT

The following case will enable students to comprehend and apply Federal Income Tax laws pertaining to the concepts of Alternative Minimum Tax, Net Operating Losses, and the their effects on the determination of income tax liability for individual taxpayers. What was once a unique situation, this case illustrates what will be a new normal in the tax professional's environment when faced with clients who have suffered previous financial losses and who are now losing investment real estate through foreclosure proceedings where the individuals are liable for outstanding debt.

Keywords: Alternative minimum tax, Net operating losses, and Cancellation of debt.

CASE INFORMATION

Elouise Jenkins retired from her state job in 2002 and perused a lucrative career as a real estate professional and stock market investor. Although Elouise initially thought that real estate and stock investments would supplement her retirement income, she soon realized that her gains far surpassed that of her retirement earnings. Never being in this position prior to this point in her life Elouise wanted to take full advantage of her new found wealth and continue to benefit from gains in the stock and real estate markets for years to come.

Elouise's first husband passed away in 1990 and she remarried in 1999 to Mr. Hugh Jenkins. Due to financial and legal matters Elouise files as married filing separately.

From an investing standpoint Elouise was conservative in her investment strategy. Remembering prior lessons from the past Elouise did not believe in stock options, margins, calls or puts. She believed in buying low and selling high. Regarding real estate Elouise loved investment property of the non-residential commercial type especially small strip malls. Elouise stated that she did not mind earning a commission from representing her client's endeavors, but she thought that any personal investments should have a steady stream of income (i.e. Rental income), generate cash flow, and appreciate accordingly over time.

In 2003 Mr. Jenkins persuaded Elouise in investing in a vacant piece of property located in South Carolina on a private golf resort. Mr. Jenkins could not procure the property on his own and thought that it will be an excellent place for the couple to live out their golden years together when the Jenkins decided to completely retire in 2009. The property was acquired for $210,000, Elouise squeezed out the last of amount of equity from the couple's main home in order to make the down payment and the Jenkins's took out an interest only mortgage for $155,058. Mr. Jenkins reasoning relating to the mortgage was since property values were increasing at an above normal amount the couple would be in an advantageous position where they would be able to sell either their main home at a substantial profit or sell the property in South Carolina for a modest gain. Elouise informed Mr. Jenkins that he would be solely responsible for the mortgage payments and he agreed without exception.

Although everything in Elouise's financial world was heading in the right direction…up! With all of the indicators showing growth there was a foul stench in the air that Elouise did not see coming. In 2008 Elouise incurred heavy capital losses both in the stock and real estate markets and as a result Elouise incurred a net operating loss (NOL) of $414,924. Over the years leading up to 2012 Elouise had a NOL carryforward balance of $398,773. Her accountant Mrs. Geraldine Portland, CPA explained to Elouise that because of Elouise's net operating losses Elouise would be able to shield future taxable income by using the NOL to her advantage.

The Jenkin's plan to retire in 2009 arrived and went without a word or whimper. The couple struggled and sacrificed in order to meet their financial obligations. Property values were decreasing by the day, no…by the moment and Elouise found herself with her personal real estate investments at their lowest values. Although none of her investments values were less than their respective outstanding mortgage balances Elouise could not extract one more cent out any of them and her real estate commission income dried up overnight. Elouise exclaimed, "If it wasn't for social security and my retirement I would be ruined both emotionally, and financially."

In September of 2012 the proverbial slap in the face arrived when Mr. Jenkins informed Elouise that the South Carolina property was foreclosed on. Mr. Jenkins withheld any and all correspondences from Elouise regarding this matter of business thinking that he, Mr. Jenkins would be able to somehow rebound and fix this current dilemma. Elouise tried to reach out to the mortgage company, but to no avail. The financial institution informed Elouise that the Jenkins will receive a 1099 – cancellation of debt at the year's end and there was nothing left of this matter to discuss.

At the end of 2012 Elouise started gathering all necessary tax documents that would be necessary in order for Geraldine Portland, CPA to prepare Elouise's federal income taxes. A summary of Elouise Jenkins's financial affairs are as follows:

Item:	Amount ($):
W-2 wages	11,733
Interest Income	26,412
Capital Gains	217
Pensions and annuities (taxable portion)	9,471
Rental Real estate, and K-1 from partnerships	9,206
Social Security Benefits of $19,427; taxable portion	(0)
Federal taxes withheld	2,699

Elouise claimed herself and her grandson yielding two (2) exemptions on her tax return and had the following itemized deductions for 2012:

Item:	Amount ($):
Deductible medical expenses	1,199
General sales tax exemption	2,373
Home mortgage interest (Form 1098)	20,588

The following information is regarding the 1099-Cancellation of debt sent to Elouise and Mr. Jenkins.

Debt Information:	Yes or (no)
Type of debt was secured	Yes
Type of property was real property	Yes
Usage of the property: personal	Yes
Was the parties personally liable for the debt	Yes
Ownership of property: Joint ownership	Yes
Item:	Amount ($)
Cost of property	210,000
Outstanding balance (debt)	155,058
Fair Market Value of the property:	20,511

Requirements:

1. Regarding the 1099-Cancellation of debt determine the amount of debt that Elouise has to claim as income in determining her federal tax obligations.
2. What is Elouise's 2012 Modified Adjusted Gross Income (MAGI)? (In determining Elouise's MAGI incorporate the following two items into your determination; a) Royalty

and nonpassive rental activities income or loss of $4,420 and b) Nonpassive S corporation income or loss of $26,879.)
3. Determine Elouise's 2012 tax liability. (Include $119 Depreciation on assets placed in service after 1986 in federal form 6251 Alternative minimum tax – individuals.)
4. Explain to Elouise why her tax liability increased dramatically in 2012 as opposed to prior tax years where her tax liability was zero (0) and she received 100% of her withheld taxes as a refund.
5. What should have Mrs. Portland, CPA explained to Elouise when the topic was discussed about Elouise's net operating losses and future tax liability?

TEACHING NOTES FOR THE INSTRUCTOR

Case Overview

From a federal income tax standpoint this case gives a unique perspective of how under certain conditions Net Operating Losses (NOL) for an individual can trigger Alternative Minimum Tax (AMT) for the taxpayer. Although from a historical perspective this situation was considered an exception rather that the rule, the financial debacle of 2008 has caused an increase in cases where NOL's for individuals generates an AMT to be calculated and assessed on the federal tax return.

The perspective user of this case will receive experience in determining the correct tax liability to be assessed on a federal tax return and hopefully spot the signs in order to advise the taxpayer of what appropriate actions that is needed to be taken in order to circumvent any increases in the tax liability of the individual.

Learning objectives and suggested use of the case are as follows:

1. How to determine Alternative Minimum Tax (AMT) for an individual tax payer.
2. How net operating losses of an individual figures in the determination of AMT.
3. Accountant's responsible in advising their clients in an accurate and concise manner.

Suggested Audience

This case is intended for students enrolled in a US federal income tax course for individuals.

Solutions Manual:

1. Regarding the 1099-Cancellation of debt determine the amount of debt that Elouise has to claim as income in determining her federal tax obligations.

Debt taxpayers were considered personally responsible for:	$155,058
Less: Fair market value of property	-20,511
Equals: Amount of debt that is cancelled by financial institution	134,547
Divided by 50% (Ownership for each taxpayer)	50%
Elouise's portion of cancelled debt to be recorded as income (rounded)	$67,247

2. What is Elouise's 2012 Modified Adjusted Gross Income (MAGI)? (In determining Elouise's MAGI please incorporate the following two items into your determination a)

Royalty and nonpassive rental activities income or (loss) of $4,420 and b) Nonpassive S corporation income or (loss) of $26,879.)

Using IRS Passive Activity Loss ATG - Exhibit 2.2: Modified Adjusted Gross Income Computation (only the line items affected will be illustrated):

Items:	Amounts ($)
Wages	11,733
Interest Income	26,412
Royalty and nonpassive rental activity income or loss	4,420
Nonpassive S corporation income or loss	26,879
Capital gains and losses	217
Taxable pension distributions	9,471
Other income (refer to note A)	(331,499)
Modified adjusted gross income	(252,367)
Note (A)	
Net Operating loss	(398,773)
Cancelled debt income	67,274
Total other income	(331,499)

3. Determine Elouise's 2012 tax liability.

Wages	11,733
Interest Income	26,412
Capital Gains	217
Taxable pension distributions	9,471
Taxable social security benefits	(0)
Other Income	(331,499)
Adjusted gross income	(274,460)
Less: Itemized deductions	(24,160)
Less: Exemptions	(7,600)
Taxable income	(0)
AMT (refer to note B)	18,247
Less: Income tax withheld from form W-2	(2,699)
2012 tax liability for Elouise	15,548

Note B: Illustrated using federal form 6251 and only illustrated affected line items:

Line 41 of federal form 1040 (AGI of 274,460 + Itemized deductions of 24,160)	(298,620)
Taxes from schedule A line 9	2,373
Net operating losses	398,773
Depreciation on assets placed in service after 1986	119
Alternative minimum taxable income	102,645
Less: Exemption	(32,464)
Subtotal	70,181
(x) by 26% (rounded) here is Elouise's AMT	18,247

4. Explain to Elouise why her tax liability increased dramatically in 2012 as opposed to prior tax years where her tax liability was zero (0) and she received 100% of her withheld taxes as a refund.

    According to the Internal Revenue Service, "When preparing an individual's federal tax return the preparer calculates both the regular and AMT (tentative tax) taxes. The individual taxpayer will pay the higher between regular and AMT."

    In determining Elouise Jenkins's 2012 tax liability the principle reason why she was assessed such a large tax liability is found in the calculation of the alternative minimum tax. Within the AMT formula the main item found within this case is treating Net operating losses (NOL) as a positive amount. Elouise had incurred rather a large NOL carryforward coupled with the 1099-cancelled debt that caused an assessment of alternative minimum tax.

5. What should have Mrs. Portland, CPA explained to Elouise when the topic was discussed about Elouise's net operating losses and future tax liability?

    Mrs. Portland should have either done one of two things with respect to Elouise's tax situation. First, if Mrs. Portland, CPA was retained just to prepare Elouise Jenkins's tax return she should refrained from giving advice pertaining to using Elouise's net operating losses to her advantage in reducing future tax liabilities. Second, if Mrs. Portland, CPA was retained as a consultant on this matter of business, Mrs. Portland should have explained to Elouise both sides of the issue regarding how a net operating losses could zero out regular tax liability and trigger an assessment of alternative minimum tax. The accountant should have given scenarios (i.e. cancellation of debt scenario among others) that would have prepared Elouise for the shock of being assessed a tentative tax or help the taxpayer in following a course of action in order to avoid future tax liability.

References:

TITLE 26, Subtitle A, CHAPTER 1, Subchapter A, PART VI (IRC § 55, 56, 57, 58, & 59.)
Internal Revenue Service, *Publication 536 – Net Operating Losses*, for use in preparing 2012 returns.
Internal Revenue Service, Topic 556 - Alternative Minimum Tax.
Federal Form 6251 (Alternative Minimum Tax for individuals)
Internal Revenue Service; Passive Activity Loss ATG - Exhibit 2.2: Modified Adjusted Gross Income Computation
IRC § 810