

The Alternative Minimum Tax

Not just for the wealthy

Topical Education for Today's Investor

INCOME TAXES

When first introduced in 1969, the Alternative Minimum Tax (AMT) was widely acknowledged to be a “rich man’s tax” — a fallback tax for those wily taxpayers with big incomes and numerous deductibles. But because the AMT has been adjusted for inflation only twice in 30 years, it is now encroaching upon the middle class.



The mechanics of the AMT are complex. But a general understanding of how the tax works can help you avoid it and even seek to use it to your advantage.

The Other Federal Tax

The AMT truly functions as an “alternative” tax system. It has its own set of rates and rules for deductions, which are more restrictive than the regular rules. It operates in parallel with the regular income tax system in that if you’re already paying at least as much under the “regular” income tax as you would under AMT, you don’t have to pay it. But if your regular tax falls below this minimum, you have to make up the difference by paying the alternative minimum tax.

AMT can be triggered by a number of different variables. Although those with higher incomes are more susceptible to the tax, many other factors such as the amount of your exemptions or deductions can also prompt the tax. Even commonplace items such as a deduction for state income tax or interest on a second mortgage can set off the AMT. To find out if you are subject to the AMT, fill out the worksheets provided with the instructions to Form 1040 or complete Form 6251, Alternative Minimum Tax — Individuals.

AMT rates start at 26%, rising to 28% at higher income levels. This compares with regular federal tax rates, which start at 10% and step up to 35%. Although the AMT rates may appear to cap out at a lower rate than regular taxes, the AMT calculation allows significantly fewer deductions, making for a potentially bigger bottom-line tax bite. Unlike regular taxes, you cannot claim exemptions for yourself or other dependents, nor may you claim the standard deduction. You also cannot deduct state and local tax, property tax, and a number of other itemized deductions, including your home-equity loan interest, if the loan proceeds are not used for home improvements. Accordingly, the more exemptions and deductions you normally claim, the more likely it is that you’ll have an AMT liability.

On the positive side, AMT does allow you to apply a special AMT exemption — \$62,550 for joint filers and \$42,500 for singles in 2006 — designed to prevent the AMT from applying to taxpayers with modest incomes. But this exemption is currently slated to decrease for the 2007 tax year, to \$33,750 and \$45,000 for single and married filers, respectively, unless Congress increases them.

There's also an "AMT credit" that allows you to claim a credit on your tax return in future years for some of the extra taxes you paid under the AMT. However, you can only use the AMT credit in a year when you're not paying the AMT. To apply for the credit, you'll need to fill in yet another form, Form 8801, to see if you are eligible.

AMT Red Flags

Certain circumstances and tax items are likely to trigger the AMT:

- If your gross income is above \$100,000.
- If you have large numbers of personal exemptions.
- If you have significant itemized deductions for state and local taxes, home equity loan interest, deductible medical expenses, or other miscellaneous deductions.
- If you exercised incentive stock options (ISOs) during the year.
- If you had a large capital gain.
- If you own a business, rental properties, partnership interests, or S corporation stock.

If any of the above apply to you, you should complete the AMT worksheet when preparing your taxes. If you don't, rest assured that the IRS will. And if they find that you owe AMT, they'll add penalties and interest. Worse yet, not paying your AMT liability may trigger an IRS audit.

Avoiding the AMT

Because large one-time gains and big deductions that trigger the AMT are sometimes controllable, you may be able to avoid or minimize the impact of the AMT by planning ahead. Here are some practical suggestions.

- **Time your capital gains.** You may be able to delay an asset sale until after the end of the year, or spread a gain over a number of years by using an installment sale. If you're looking to liquidate an investment with a long-term gain, you should review your AMT consequences and determine what impact such a sale might have on your overall tax situation.
- **Time your deductible expenses.** When possible, time payments of state and local taxes, home-equity loan interest (if the loan proceeds are not used for home improvements), and other miscellaneous itemized deductions to fall in years when you won't face the AMT. Since they are not AMT deductible, they will go unused in a year when you pay the AMT. The same holds true for medical deductions, which face stricter deduction rules for the AMT.
- **Look before you exercise.** Exercising ISOs is a red flag for triggering the AMT. The AMT on ISO proceeds can be significant. Because ISO tax issues are complex, you should consult with your tax advisor before exercising ISOs.

AMT Red Flags: Incentive Stock Options

When you exercise an incentive stock option, you must report an adjustment for AMT purposes. The adjustment equals the difference between the exercise price and the fair market price.

EXAMPLE: You exercise an incentive stock option to purchase 1000 shares of your company's stock at \$20 per share when the stock is trading at \$50 per share. For AMT purposes, you must report an adjustment of \$30,000 $(\$50 - \$20) \times 1000$.

Points to Remember

1. The AMT has its own set of rates and rules for deductions, which are generally more restrictive than regular federal tax rules.
2. The AMT generally kicks in at higher income levels, but a variety of different variables can trigger the tax, including large numbers of deductions.
3. The AMT calculation allows significantly fewer deductions than regular tax calculations, making for a potentially bigger bottom-line tax bite.
4. By planning ahead and timing your capital gains, deductible expenses, and exercising of ISOs, you may be able to avoid or minimize the impact of AMT.

For more information, please consult with your financial advisor.

Important Additional Notes

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