

The Short Answer

Are You Vulnerable to the Alternative Minimum Tax?

By Christine Benz | 10-18-05 | 06:00 AM

So many things in life--whether it's buying a house, getting a dog, or traveling--don't become truly interesting until you've actually been through them yourself. After that, they're the source of endless analysis and discussion. Which contractor did you use to upgrade your electrical service? How long did you keep Sparky in the crate before you gave him run of the house? Where did you go when you were in Spain?

So it is with the Alternative Minimum Tax (AMT)--only it's not typically the subject of block-party chatter. By now, you've most certainly heard that the AMT is something you should be aware of. You've also no doubt heard that the AMT, which was originally designed to keep the ultrarich from skirting taxes altogether, will ensnare more and more middle-class taxpayers in the coming years--a reported 15 million in 2006 and 29 million (that's one third of all taxpayers, folks) by 2010. But until you've had to pay it or until someone you know well has shared an AMT horror story, it's hard to get too excited about the AMT.

However, as I noted in a [recent column](#), it's important to know the basics about this parallel tax system--particularly if you're an active investor. In this week's column, I'll outline what the AMT is and enumerate some of the key factors that could put you into the AMT zone. In next week's column, I'll discuss some steps you can take to help reduce your AMT tab.

AMT Basics

The AMT is--as its name suggests--an alternative way of calculating your taxes. Essentially, if the IRS deems you're paying too little under the regular tax system, it forces you to use the AMT calculation, under which your taxes will be higher. The AMT was originally created in 1969 to ensure that wealthy individuals who had managed to skirt taxes under the conventional tax system didn't avoid paying taxes altogether. But because the rules regarding AMT liability haven't been updated to the extent that the regular income-tax code has been, more and more taxpayers are apt to find themselves on the hook for AMT in the years ahead.

If you've done your own taxes before, you've seen the AMT in action. Essentially, you calculate your taxes under the conventional tax system, then (as directed by line 44 on the 1040 form) you calculate your taxes using the AMT system, using a different set of rules.

Notably, the AMT and regular tax systems differ in what they consider taxable income--for example, the AMT system taxes income from private-activity bonds (municipal bonds used to fund sports arenas and the like), whereas municipal-bond income is wholly tax-exempt under the regular tax system.

In addition, certain credits, exclusions, and deductions that are available to you when calculating your regular tax liability are not usable for the purposes of calculating your AMT liability, and vice versa. For example, you can claim your property taxes as a deduction when calculating your regular tax burden, but it's not an allowable deduction for AMT purposes. (If you live in a high tax area, losing that deduction can be mighty painful.) In general, it's safe to say that the AMT system is less generous than the regular tax system in granting credits, exemptions, exclusions, and deductions, and that's partly why the AMT has

become the source of so many complaints of late.

Once you've calculated both your conventional and AMT tax liability, you compare the two numbers. If the regular tax liability is higher, you simply pay that amount. But if the AMT liability is higher, you pay your regular tax liability plus the AMT amount that's over and above the regular tax amount.

Common Triggers

So now you're probably wondering if you're likely to be on the hook for the AMT. That's a common question, but the answer is complicated.

In general, taxpayers with household incomes between \$150,000 and \$500,000 will tend to be most vulnerable to AMT, though it's possible to be on the hook for AMT with a lower income than that. You further ratchet up your potential for AMT liability if you take a lot of deductions, exemptions, and credits on your regular income tax return. That's because many of these tax-lowering mechanisms, while allowable on your regular tax return, are not usable when you calculate your AMT liability. Thus, your AMT liability is very likely to be higher than your regular tax liability and that, in turn, means you'll owe AMT.

For example, if you have a large family, you can claim exemptions for yourself, your spouse, and each of your kids on your regular tax return, but the AMT doesn't allow these personal and dependent exemptions. Deductions for some medical expenses; interest on home-equity loans that you're not using to buy, build, or upgrade your home; state and local taxes; unreimbursed employee expenses; and investment-related expenses are also not allowable under the AMT system. If you're using a combination of these exemptions and deductions, you're a potential target for AMT. You're also an AMT target if you don't itemize your deductions, as the AMT system doesn't allow a standard deduction. (Higher earners, who are most vulnerable to AMT in the first place, usually itemize their deductions, however, so this isn't likely to be a problem for too many taxpayers.)

On the other side of the ledger, you also need to be mindful of certain sources of income, as they too, can affect your AMT liability. As I noted earlier, income from municipal bonds issued to finance private activities is not subject to regular income tax, but it is subject to AMT.

Incentive stock options (ISOs) are by far the largest income trigger for AMT liability, however, and that's why you so often hear "stock options" and "AMT" in the same breath. If you have exercised ISOs and your company's stock price was a lot higher at the time of exercise than it was when your company granted you the options, there's a good chance you'll owe AMT for the year in which you exercised.

Here's an example of how it works: Say your company granted you 1,000 incentive stock options in 1997 at the price of \$5 apiece. By the time you exercised your options in 2005 and bought the stock, however, the shares had risen to \$17. If you decide to hang on to your new shares because you like your company's prospects, you won't owe anything under the regular tax system; after all, you haven't sold shares and pocketed a gain.

That's logical, but the AMT system sees it differently. For AMT purposes, the \$12 spread between the option price and the exercise price--the so-called bargain element--is considered income, even if you haven't yet sold a single share of your company stock. And

here's the really insidious part: If the stock were to slip to \$3 after you've exercised your options, you're still on the hook for AMT taxes on that \$12 per share in income--even though you actually have a loss in your own position. (On the plus side, your new "basis" in the stock is the higher number--\$17. So if the stock goes back up to \$17 and you sell at that level, you won't owe the IRS a penny.)

In next week's column, I'll discuss ways you can control--and perhaps even reduce--your AMT exposure by manipulating some of the factors that affect your AMT burden.

Christine Benz is Morningstar's director of mutual fund analysis. She is also the author of the second edition of the *Morningstar Guide to Mutual Funds: 5-Star Strategies for Success*. Although she reads every e-mail she receives, she cannot respond to each message individually or provide individualized portfolio advice.