

It Could Happen to you

A killer tax reaches down from the ranks of millionaires to the merely well-off, and cherished breaks disappear.

By Mary Beth Franklin and blank and blank

From *Kiplinger's Personal Finance* magazine, February 2005

Thirty-five years after it was created to backstop the income tax so that wealthy Americans paid at least a pittance in taxes, the alternative minimum tax is rapidly morphing into a mass tax. Nina Olson, the IRS's national taxpayer advocate, calls the AMT "the most serious problem facing American taxpayers." This year, three million of us (up from about 130,000 in 1990) will find ourselves in a parallel universe, where common tax breaks -- including deductions for state and local taxes and home-equity-loan interest, and write-offs for the cost of tax and investment advice and for the value of personal exemptions for ourselves and our kids -- simply don't exist. Unless Congress acts, 30 million people -- one in four taxpayers -- will be living in AMT land by the end of the decade.

Theoretically, all taxpayers are subject to the AMT, but you pay it only when your AMT liability exceeds your regular tax bill. That means figuring your taxes twice -- once under the regular rules and again under the AMT rules. Ironically, as regular tax bills shrink, thanks to the tax cuts of 2001 and 2003, the chances that your AMT bill may be higher increase. In a very real sense, the AMT can sneakily taketh some of what the tax cuts giveth.

In most cases, the AMT adds several hundred to a few thousand dollars to a tax bill. But the AMT has smacked some unfortunate souls with bills of hundreds of thousands of dollars -- often many times their annual income -- because of an AMT tenet that taxes paper profits when stock options are exercised rather than when the stock is sold. For such victims, who saw phantom profits disappear during the tech wreck of 2000-02 but who were saddled with enormous AMT debts, the past five years have included a string of financial disasters, from garnished wages to tax liens and bankruptcies.

Although Olson and others have called for the AMT's repeal, it would be a costly proposition. As things stand now, by 2008 it would cost the government less to repeal the regular income tax than to pull the plug on the AMT. The brewing crisis is sure to play a starring role as President Bush's drive for fundamental tax reform unfolds. In the meantime, take this guided tour of the strange new world you may soon inhabit.

Funny, I don't feel rich

Gary Gunther, 49, of Annapolis, Md., makes a comfortable living as a defense contractor with a low six-figure salary. But with nine kids and a stay-at-home wife who home schools them, the Gunthers are by no means wealthy. So Gunther, who prepares his own taxes, was surprised in 2002 to discover that the family owed the AMT. The route to that verdict was an arduous one. Gunther first filled out a 12-line worksheet to determine if he might be subject to the AMT. Then he had to plow through eight pages of

instructions and complete a 65-line form to know for sure. That first year, Gunther did the calculations by hand. Now he uses tax-preparation software.

Gunther estimates that the AMT added \$2,500 to his 2002 tax bill and about half that much in 2003. He's gritting his teeth anticipating this year's AMT verdict.

Why is he subject to the fat-cat tax? Because he lives in a high-tax state and has a large family. All the income and property taxes the Gunthers deduct on their regular federal income-tax return boomerang to the bottom line for AMT calculations. So do his 11 personal exemptions -- one each for him, his wife, Mary, and their nine children, who range in age from 1 year to 16. That's \$34,100 that comes off his taxable income under the regular rules but gets taxed at 26% by the AMT.

"Less money in our pocket means less money to spend on our kids," says Mary, who, like her husband, is a former naval officer. "Although Gary makes a pretty good salary, we don't live an outrageous lifestyle." The family moved in 2001 into Mary's childhood home across the Severn River from the Naval Academy after living all over the world on military posts. "We drive two beat-up cars, and we don't own a yacht," she says.

Michael Kitces, a financial planner in nearby Columbia, Md., says more than half of his clients are vulnerable to the AMT -- primarily because the state and local tax deductions and personal exemptions that cut their regular tax bills disappear under the AMT. And because they're in the same boat year after year, there's really no way for most of them to avoid the AMT by delaying or accelerating certain tax payments or income.

"Once people cross the threshold and wind up paying the AMT, there's not a whole lot they can do to get out of it," Kitces says. "They are going to stay in AMT land until Congress changes the law."

As the AMT storm gathers, Congress seems reluctant to act. Last fall, lawmakers temporarily raised the AMT exemption -- a sort-of super standard deduction that taxpayers subtract from bloated AMT income before applying the tax (26% on the first \$175,000, and 28% on any excess). For 2004 and 2005, the exemption is \$58,000 for married couples and \$40,250 for single filers. But in 2006, the amounts are scheduled to drop back to \$45,000 and \$33,750. (If the original \$30,000 AMT exemption had been indexed for inflation back in 1969 when the law was enacted, it would equal about \$150,000 today.)

"We have a stay of execution, but we're still on death row," says Linda Carlisle, a partner with the White & Case law firm, in Washington, D.C, and a former Treasury Department official. "By 2010, the AMT will be a real taxpayer issue, but you can't wait until 2010 to fix it." Calling it a "cards and letters" topic, Carlisle predicts Congress won't act to do anything about the AMT until the public starts to complain loudly.

That's the kind of pressure that prompted Congress to create the AMT in the first place. According to one report, lawmakers received more mail in 1969 over a study that discovered that 155 taxpayers with incomes of \$200,000 or more (about \$1 million in today's dollars) had escaped paying income tax in 1966 than they received about the Vietnam War.

In 2003, about 600 Americans with incomes of \$1 million or more avoided paying any income or AMT tax, according to the Tax Policy Center, a joint venture of the Urban Institute and the Brookings Institution. Yet the AMT is alive and well, and trickling down into the middle class. The center projects that by 2010, more than half of AMT taxpayers will have incomes of \$100,000 or less -- up from about

9% today. For now, the majority of people paying the AMT have incomes between \$100,000 and \$500,000 (see the box on page 85 to find out whether you're threatened by the AMT).

A matter of timing

Taxpayers who are susceptible to the AMT just because of the sheer size of their families or their state and local tax bills have few options to avoid the parallel tax. But for others, timing does matter. For example, if you expect to cross the threshold into the AMT in 2006, but still play by the regular rules in 2005, you may want to accelerate deductible expenses, such as property taxes and state income taxes, into this year. In an AMT year, the write-offs have no value.

Although long-term capital gains on the sale of stock or other assets are taxed at the same 15% rate under both the regular rules and the AMT rules, a big gain can push you into the AMT. How? Because as income rises above \$150,000 on joint returns and \$112,500 on single returns, the AMT exemption amount is gradually phased out. As a big profit squeezes the exemption, the AMT becomes more threatening.

Once you know you'll get hit with the AMT, it can pay off to push as much income as possible into the AMT year because it will be taxed at the top AMT rate of 28%, compared with the top rate of 35% under regular tax rules. If you have the option of taking a lump-sum payment or spreading a gain over several years, financial planner Kitces says it is usually better to take the gain all at once. Sure, that can mean a major tax hit. But by spreading the gain over several years, you risk losing your AMT exemption year after year and paying more tax than you would if you simply bit the bullet.

Phantom wealth

No one understands the importance of timing better than people who exercised stock options in early 2000 and then watched their paper profits disappear as the tech bubble burst. Under the regular tax rules, the difference between the discounted price you pay to exercise incentive stock options and the stock's value on the day of the transaction is ignored until the stock is sold. In AMT land, however, the instant paper profit is considered taxable income right away.

Nina Doherty of Chantilly, Va., knows the pain this can cause. In March 2000, she exercised options for 20,000 shares of stock of her employer, Net2000 Communications, the day before it went public. As the first employee of the small telecommunications company, it looked like her years of hard work had really paid off: The paper profit was nearly \$800,000. But by the end of 2001, the company was out of business, the stock was worthless, and Doherty, 42, was still on the hook for an AMT bill of about \$100,000. She still owes more than \$50,000 -- and that's after the IRS confiscated \$30,000 from a joint bank account she held with her husband, Micky. It was money he borrowed from his 401(k) to pay for household repairs and replace the family's aging minivan. But the IRS got there first, and then it slapped a lien on their home.

"Now my family is facing financial ruin," Doherty told the House Ways and Means Committee in a special hearing looking into the AMT last summer.

When the AMT is triggered by exercising stock options, you are supposedly being forced to pay tax sooner rather than later on the profit you'll score when you sell the stock. What you pay in AMT on the anticipated income becomes a credit to offset the tax when you sell the shares. But if the sale produces a

loss--an eventuality that apparently was not seriously considered when the AMT was created -- you can be stuck with a credit that's difficult to use. Doherty figures it will take 30-plus years to recover the AMT she paid on a profit that never materialized.

The AMT also destroyed Rita Miller's finances--and has affected her husband's professional reputation as well. Their journey through AMT hell started in 1999, when she exercised stock options while working at VeriSign. "When we got this opportunity, we thought we were going to be able to help our family and live the American dream. Then -- *bam* -- we owed hundreds of thousands of dollars," she says. "It's been a living nightmare."

The Millers, who live in Catonsville, Md., have already paid more than \$300,000 in taxes on paper gains that disappeared when the stock market collapsed. They still owed more than \$125,000 when she and her husband, Art, both lost their jobs in 2002. Rita, 57, has since landed a job with the federal government, but Art, 59, was denied a security clearance when he applied for a government job because of the pending tax matter.

Doherty and Miller have joined the Coalition for Tax Fairness, an organization lobbying Congress for changes in the AMT rules. Among other things, they want to accelerate the use of the AMT credit so that people who pay taxes on phantom gains can recover the overpayments more quickly.

--Research: *Jessica Anderson*

AMT THREAT LEVEL

What, Me Worry?

The world of the alternative minimum tax is a scary place. But should you be worried? Michael Kitces, a financial planner in Columbia, Md., prepared the table below to help you judge your vulnerability. Based on your taxable income under the regular rules, shown in the column on the left, the AMT is a real threat when the "extra" income captured by the AMT's wider net equals or exceeds the amount shown in the column on the right that matches your filing status.

Among other things, the "add backs" include what you may deduct under the regular rules for state and local taxes and home-equity-loan interest, and the value of personal exemptions you claim for yourself and your children (\$3,100 each for 2004). The AMT also counts as income the difference between what you pay for stock bought with incentive stock options and what the shares are worth at the time you buy them.

§ Regular taxable income	Added income under AMT	
	Married	Single
\$50,000	\$34,096	\$25,779
100,000	29,058	24,322
150,000	24,731	17,899
200,000	20,757	16,596
300,000	15,043	20,677
400,000	21,939	44,313
500,000	46,939	69,313

This page printed from: <http://www.kiplinger.com/magazine/archives/2005/02/amt.html>

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