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The Basics 5 ways to beat the AMT

The Alternative Minimum Tax was created to keep rich taxpayers from putting one over on Uncle Sam. Today, despite all the tax cuts, it can still be a tax thorn in the Average Joe's side.

By [Jeff Schnepfer](#)

Marile Robinson, 52, had just bought her dream home a few years ago when her accountant gave her a nasty shock: She owed an unexpected \$290,000 in taxes.

Robinson, who earns \$75,000 a year as a human resources director at Intel, had no choice but to sell the house and take out a loan to pay off the tax bill. Im starting from scratch, and Im in my 50s, Robinson said. Her monthly take-home pay is equivalent to the monthly interest on her loan.

It turns out that Robinson, like more and more middle-income folks each year, got slapped with the alternative minimum tax, a tax system thats separate from the regular income tax and comes with its own rates and rules. By 2010, the Internal Revenue Service estimates, more than 35 million taxpayers will be subject to the tax.

While the AMT is intended to strike super-wealthy taxpayers, its often called the stealth tax because it sneaks up on so many unsuspecting people. Indeed, it is by far one of the most dreaded provisions in the tax code. You're likely to confront the AMT, for example, if you make \$100,000 or more a year -- or if you make \$75,000 and write off such mundane things as state taxes and interest on a home-equity loan. The AMT isn't about how much you earn, really; it's about making sure that no one has so many deductions and credits he doesn't pay *some* tax.

The only deductions allowed under the AMT are for mortgage interest and charitable contributions. So even though the AMT doesnt look so fierce when you look at its tax rates -- 26% and 28%, compared to the 35% top income tax rate for 2004 and 2005 -- more income is taxed, so it always produces a higher tax bill.

To figure out if youre in the AMT, you must calculate your taxes under the AMT system on a Form 6251 and under the regular income tax system on a Form 1040. If your AMT bill is higher, that means youre in the AMT, and youre required to pay the larger bill. Everyone is supposed to run the calculations to see if theyre liable, a Treasury official says.

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Common AMT pitfalls

The minimum tax works in complicated ways and can snare you for reasons you don't expect. Robinson was hit by the AMT because she exercised incentive stock options without understanding -- and planning for -- the tax consequences. But you don't have to have unusual investments or an elaborate tax return to fall into the trap.

But the larger problem is personal and dependent exemptions, the standard deduction, state and local taxes, and miscellaneous itemized deductions. In fact, the IRS estimates that by 2007, nearly 95 percent of AMT revenues will be attributable to these deductions.

Simply living in a high-tax state such as California, Michigan or New York and having high property taxes can be enough to push you into the AMT.

Consider, for example, a family of four in New York with a household income of \$200,000 and state income taxes of \$12,645. If their property tax were even a dollar more than \$9,655 -- which is quite possible in New York City suburbs -- the family would be subject to the AMT, says Ed Slott, a tax adviser in Rockville Centre, N.Y. Their tax bill, he says, would be just over \$42,500 no matter how many deductions they claim for state taxes, property taxes and miscellaneous itemized expenses. They could have \$10,000 in miscellaneous expenses and they wouldn't be able to deduct a dime of it," Slott says. They would also lose personal exemptions. For every dollar a deduction might reduce your tax bill, the AMT adds the dollar back.

Another sign of how out of control the AMT has gotten, says one Treasury official, is that some families get socked with the minimum tax simply because they have many children and claim numerous personal exemptions.

We have estimated that nearly the entire AMT liability is simply from taxpayers claiming the personal exemption and state and local tax deductions, the official says. And that's no small potatoes: The government collected \$10.3 billion from individual AMT taxpayers 2001. Most people don't think they're engaging in tax sheltering when they're claiming the personal exemption or state taxes, he says, but they are treated that way when they get hit with the AMT.

Alfred Maiorano, 47, of Orange, Conn., met with the AMT for yet another reason: He claimed a deduction for capital depreciation in his three small video companies. (He organizes his businesses as S corporations so profits

and losses flow through to his personal tax return.)

Its not that Im wealthy -- far from it, says Maiorano, who employs 14 people. I wouldnt even call myself upper-middle class. But under the AMT, you lose the deduction for depreciation, and the loss of the deduction boosts his tax bill immediately. Ive been severely affected by the AMT for the past three years, he says.

In future years when he is not subject to the AMT (assuming his circumstances change and he can avoid getting socked by the AMT), Maiorano will be able to claim a credit to help recoup what he paid under the minimum tax, thanks to a special rule under the tax code. But still, he says, that doesnt help him come up with the cash to pay the tax.

Another AMT trap: taking large long-term capital gains. Gains are taxed at 15% under the regular tax system and 20% under the AMT system. In effect, you're penalized with the AMT. And it may be more likely that modest deductions will reduce your regular tax enough to trigger the tax.

Consider what happens if, for the sake of an example, all you have are long-term capital gains of \$100,000. Your tax bill under the AMT and the regular system would be \$20,000, and you wouldnt be subject to the AMT. But as soon as you factor in a deduction -- say, for state income taxes -- your regular tax bill drops and whoosh! You become subject to the AMT.

Even taking extra-large charitable contributions can sink you into the AMT. True, charitable deductions are allowed under the AMT. But assuming your regular tax rate is higher than the AMTs top rate of 28%, the deduction will be more valuable under the regular income tax. In effect, it will reduce your income by more under the regular tax system than the AMT. Depending on what other deductions you have, and other factors, that can be enough to trigger the minimum tax.

Incentive stock options: an AMT guarantee

Perhaps the surest AMT trigger is exercising incentive stock options. Under the AMT, you have to count the difference between the exercise price and the market price as income. If, for example, your exercise price is \$20 and the market price is \$60, you have to count \$40 per share as income.

ISO's have been the cause of a lot of angst, says Michael S. Rubin, a principal and director of client tax services at Bessemer Trust, a New York City-based private banking firm. Theyve thrown some taxpayers hundreds of thousands

of dollars deep into the AMT.

For more on the tax issues of stock options, see [To avoid a tax burn, know your \(stock\) options](#).

The AMT was created in 1969 as a failsafe to ensure that the super-rich couldn't avoid taxes through elaborate tax shelters. But its bite is being felt by taxpayers of all backgrounds because the AMT tax rates haven't changed, while the regular tax system's tax bracket breakpoints, personal exemptions and standard deductions have been indexed to inflation and modified by an excitable Congress eager to show it can cut taxes.

The 2001 and 2003 tax laws offered little help

The 2001 Economic Growth and Tax Relief Reconciliation Act did nothing to cure the AMT's long-term rampage. To be sure, it did increase the AMT exemption amounts moderately. The AMT exemption works much the same as the standard deduction under the regular tax system -- after calculating your taxable income under the AMT, you can exempt a portion of your income from taxation. The exemption phases out completely for joint filers with income of \$346,000 and singles earning \$255,500. Under the 2003 tax law, the exemption was raised to \$40,250 from \$35,750 for singles, and to \$58,000 from \$49,000 for couples.

Congress extended these exemptions in September 2004. Still, the AMT will cast an even wider net than it would have before the tax act was passed. The Treasury Department estimates that the number of individuals who will pay the AMT will rise from 2.7 million in 2003 to that 35 million projection for 2010. Prior to the tax act, some 18 million were expected to experience the AMT's bite by 2010.

Many policy analysts and tax specialists say the AMT is unfair and should be reformed -- some even argue for a repeal, saying the AMT is no longer needed. The 1986 tax act closed the loopholes that the AMT was supposed to protect against, yet that's when the AMT was amended into its current state to ensure that the loopholes remained closed. It was a belt and suspenders kind of thing, says Clint Stretch, director of tax policy for Deloitte & Touche in Washington D.C.

But few lawmakers are willing to rally behind the issue because it's such a revenue loser. The Treasury estimates that the government would lose \$500 billion over 10 years if the AMT were repealed. Nobody wants to put their head in the guillotine and talk about it, says Al Davis, senior economist with

the Democratic staff of the House Ways and Means Committee.

What you can do: 5 strategies

Other than to write to your representative in Congress, your best bet is to figure out now whether you may be subject to the AMT. That way, you'll have time to try to dodge it, or at least lessen its blow. Here are a few strategies to consider:

- **Turn your tax planning on its head.** The usual way to try to keep a lid on your tax bill is to accelerate deductions and postpone as much income as possible. But if you're at risk of falling into the AMT or you're already in it, consider doing the exact opposite, Rubin says. The more ordinary income you have relative to your deductions, the less likely you will be in the AMT -- or, the less it will sting.
- **Time your state tax payments.** When you pay your state taxes can determine if you get snared by the AMT -- and by how much. Your aim should be to match your state tax deduction with a high-income year. Here's how: If your income is high this year, consider paying all of your state taxes or accelerate tax payments before year-end -- rather than waiting until just before your tax-filing deadline next year. If you ante up before Dec. 31, you can deduct your taxes on your 2004 return. If you expect your income to be unusually low this year, wait until after Dec. 31 to pay your state taxes. Whatever portion of your state taxes you pay after year-end can be deducted on your 2005 return.
- **Before tapping long-term capital gains, plan thoroughly.** Before drawing gains, run the numbers to find out how much you can safely withdraw without triggering the AMT. Take a smaller amount of gains over several years if you have to, Rubin says.
- **Avoid private-activity bonds.** There is a certain kind of municipal bond called a private activity bond that loses its tax-free status under the minimum tax. Private activity bonds are issued by private companies for projects that benefit the public, such as airports, seaports and stadiums. If you're worried about getting bumped into the AMT or you're in it, you will probably want to dump these.
- **Exercise incentive stock options gradually, and with care.** Your best chance at avoiding the AMT when it comes to ISOs, is to exercise them gradually -- a few a year -- and when the gap between your exercise price and the market price has narrowed. And consider a couple of tricks: If you're ready to exercise your options and you're worried about coming up with the cash to pay the AMT, you can exercise them early in the year, hold them for at least 12 months, then sell them prior to your tax-filing deadline. That way, you get the

advantage of the new 15% long-term capital gains rate when you sell, and you will have raised cash from the stock sale to pay the AMT. The danger, of course, is that the share price tanks. If this happens before the end of the year in which you exercised, you can sell the shares before Dec. 31. That wipes out the AMT issue altogether.

Remember, however, that whatever AMT strategy you consider, always be sure it makes sense for your overall long-term economic picture. Steps you take could spare you from the AMT this year, but throw you into it next year, Rubin says. Always plan at least two years at a time.

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