

Tax aimed at wealthy expanding its reach

Middle class soon will feel the pinch

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WASHINGTON – Angela Hartley's story should strike fear in any honest, tax-paying citizen.

Because of a tax law that even the IRS' ombudswoman says is unfair, the former corporate executive must pay a tax bill that runs into the hundreds of thousands of dollars and threatens to rob her of her Rancho Peñasquitos home, her retirement account and her son's college savings.

At issue is the 36-year-old alternative minimum tax – a provision of the country's convoluted and complex internal revenue code that was intended to nip the superwealthy but is now extending its reach well down the income ladder. If left unchanged, the little-understood tax will soon begin encroaching on the middle class.

"The stress is unbelievable," said Hartley, a single mother to 11-year-old Colin. "I've spent thousands of dollars trying to work on a compromise with the federal government, but I was told my offers would be turned down unless I paid the entire amount. That would mean selling my house and giving them several thousands of dollars a month."



DAN TREVAN / Union-Tribune
The alternative minimum tax may cost Angela Hartley her Rancho Peñasquitos home and her son's college savings.

Not every case involving the alternative minimum tax is as catastrophic as Hartley's. More typical is the situation confronting Robert, a 36-year-old San Diego tax professional whose expertise proved no protection against an unwelcome surprise. While calculating his 2004 taxes, he discovered that his family's tax bill had unexpectedly jumped \$6,000 because of the alternative minimum tax. Robert, who would discuss his situation only on the condition that his last name not be used, said he has an income in the low six figures.

Robert is one of about 3 million taxpayers whose 2004 federal tax returns will bring them within reach of the alternative minimum tax, often referred to simply as AMT. Overall, the Internal Revenue Service estimates that about 132 million individual returns will be filed this year.

A recent study by the Tax Policy Center – a joint venture of the Urban Institute and the Brookings Institution – warns that by 2010, the AMT will increase the taxes of more than 29 million taxpayers, many of them drawn from more modest financial circumstances than those of Hartley or Robert.

Not on agenda

Politicians and policy-makers have long anticipated the situation, but key Republican strategists see the problem as one created by Democrats years ago and say they feel no urgency to solve it. They also know that the victims tend to live mainly in high-income states that vote Democratic in presidential elections, such as California.

For that reason, Republican procrastinating over fixing the widely acknowledged inequities of the tax may become another form of payback in the ongoing red state-blue state power game.

"Why in the world would we cross the street to solve the Democrats' problem that they created – that primarily first screws their constituents and then everybody else?" wondered Grover Norquist, a top Republican strategist. "The answer is, yes, we'll fix it. . . . After we've gotten rid of the death tax (inheritance tax) and the capital gains tax and dropped marginal tax rates, we'll work on it."

In fact, a Republican president – Richard Nixon – signed the legislation creating the alternative minimum tax in 1969 in the wake of widespread reports of wealthy taxpayers using various tax dodges to eliminate their federal tax liability. The outgoing Lyndon B. Johnson administration and Congress' Democratic leadership supplied the impetus for the measure.

Political score-settling is only one reason for the foot-dragging. At a time of mounting concern over deficits, the cost of fixing the AMT problem is uncomfortably high. Indexing the law for inflation would cost the federal treasury \$370 billion in lost revenue over the next decade and the price tag for eliminating the tax would be \$600 billion, according to the nonpartisan Congressional Budget Office.

The AMT works in tandem with the regular federal income tax. It does so by requiring that taxpayers recalculate their federal tax by omitting some familiar – and very valuable – offsets such as state and local tax deductions and personal exemptions for dependents. The larger of the two amounts is then what is owed Uncle Sam. A combination of variables must exist for the alternative minimum tax to kick in, so it's often hard for a taxpayer to predict when the AMT would apply and how much would be owed.

Some tax-return software automatically alerts taxpayers if they are within reach of the AMT, as do IRS filing instructions.

In Robert's case, two decisions – both dictated by what he considered financial prudence – brought him within reach of the alternative minimum tax. One was to pay off his mortgage; the other involved the cashing in of an investment.

"Essentially, the AMT ate my (Bush) tax cut," Robert said. "The AMT has become a stealth tax."

The Tax Policy Center study found that in 2001, California ranked fourth among all states in the percentage of taxpayers obliged to pay the AMT. New York was No. 1.

"California has all the risk factors," said Len Burman, one of the authors of the study. "It has relatively high income taxes, and a large percentage of its population is between \$100,000 and \$500,000 (in annual income). Those are the people most likely to be on the AMT."

The top dozen states on Burman's list, counting California and New York, were all colored blue on last fall's presidential electoral map – they gave their votes to Democrat John Kerry.

'State of denial'

According to the Congressional Budget Office, less than 1 percent of all taxpayers owed tax under the AMT until 2000.

That is about to change dramatically.

Unlike the regular income tax, the AMT is not indexed for inflation, meaning that every year more and more taxpayers come within its reach even though their real incomes may not have materially increased.

In addition, the tax cuts championed by Bush have effectively exposed many unsuspecting taxpayers to the AMT by reducing their regular tax liabilities.

As a result the CBO found that about two-thirds of all middle-class taxpayers with adjusted gross incomes between \$50,000 and \$100,000 will owe taxes under the AMT by 2010.

Another feature of the tax was designed to make sure that high-flying entrepreneurs couldn't play the system by manipulating incentive stock options. But that provision has had the effect of driving many more rank-and-file employees in the high-tech sector to the brink of financial disaster, largely because they failed to grasp the law's complexities.

Five years ago, Hartley paid for stock options offered by her then-employer, Aurora Biosciences, a former San Diego biotechnology company where Hartley was director of corporate communications and investor relations. At the time, the stock options were worth almost \$100 a share. When she began selling them over the next three years, their worth had plummeted to about \$10 to \$15 a share.

Regardless, the IRS taxed the shares based on their worth when Hartley bought them – close to \$1 million – resulting in state and federal tax bills that Hartley says ran into the hundreds of thousands of dollars.

She paid part of the bills by nearly wiping out her retirement savings and taking out a home equity loan. But she cannot keep pace with a federal tax bill that grows yearly with interest and penalties. Even if she sold her home and gave all the equity to the IRS, even if she zeroed out her retirement savings, she would still owe the federal government thousands of dollars each month in payments.

"You go into almost a state of denial, that it's impossible for this to be happening," said Hartley, now an administrative operations consultant for a San Diego software company. "It's impossible to not have made any money on this stock, but to still owe more tax than my net worth and several years of my income."

Californians affected

Hartley's story is not uncommon in a state where fortunes fell with the dot-com and biotech busts.

San Francisco Bay Area resident Eric Delore was a publications manager at Commerce One Inc., a thriving technology company until it nose-dived in the dot-com crash. Now a contract technical writer, Delore recalls the "shock and panic" he felt the day his tax accountant told him he owed \$400,000 in state and federal taxes on Commerce One stock options he sold last year for a mere \$5,000. The IRS taxed him on their worth when he exercised the options in 2000 – which back then was about \$1.2 million.

"A few of the IRS people have said to me, 'Just sell your house and give us the money and you can get out of this,' " said Delore, a husband and father of two young girls. "Every decision we make now is

colored by this."

IRS ombudswoman Nina Olson has called three times for reforming the alternative minimum tax. In testimony this month before the President's Advisory Panel on Federal Tax Reform, Olson used the hypothetical illustration that she modeled on the "Brady Bunch," the 1970s TV sitcom.

In Olson's illustration, Mr. Brady, an architect, earns \$73,160 a year, while Mrs. Brady takes home \$25,000 as a part-time teacher. The couple have six children and claim the "married filing jointly" filing status, which in 2004 would earn them a standard deduction of \$9,700. Normally, the Bradys would owe \$3,394 in taxes. But when they consider the AMT, their tax bill jumps more than \$1,000, to \$4,442.

California's U.S. senators, Democrats Barbara Boxer and Dianne Feinstein, are arguing for a change in the tax. Boxer believes "the AMT needs to be fixed," said spokesman David Sandretti, who said she is working with leading Democrats on the Senate Budget Committee to address the problem.

"There is no question that middle-class Californians are being hurt by the alternative minimum tax." Feinstein said.

"Although an AMT fix is very expensive, we must find a way to ensure that middle-income taxpayers are not forced to pay higher taxes because of" it.

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