

ON PERSONAL FINANCE

Alternative tax can be a trap for the unwary

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Ron Speltz, a phone maintenance technician from Cedar Rapids, Iowa, is facing bankruptcy over a tax debt caused by phantom income. The 35-year-old father of three said the combination of unrealized gains on stock options and a little-known federal law called the "alternative minimum tax" have led him into financial ruin.

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He's not alone. Brian Morin of Crown Point, Ind., is facing a \$300,000 debt as the result of an \$80,000 stock gain. He's also a victim of the AMT, a tax once meant to ensnare wealthy scofflaws that is increasingly nabbing ordinary people in extraordinary circumstances.

Which club has the best:

_____ DJs _____ martinis _____ crowd

Each year, more Americans get sucked into the seemingly arbitrary clutches of this tax. Where just 894,000 people paid the AMT in 1998, an estimated 35 million people--roughly 1 in every 4 taxpayers--are expected to pay the AMT in 2010.

Tax experts say the AMT catches most taxpayers unaware, and in ways that are difficult to explain or justify.

"The AMT operates unfairly on most of the people who get pulled into it today," said Nina Olson, the IRS' national taxpayer advocate, who is in charge of handling the most troubling customer tax disputes. "It pulls in taxpayers who have home equity loans, people who have settled age discrimination cases, and people who have blended families. It may have made sense when it was designed in 1969, but it doesn't make any sense today."

The AMT is the result of Vietnam-era outrage at 155 high-income individuals--they each earned the equivalent of about \$1.1 million in today's dollars--who paid no income tax that year.

In the past several years, however, a number of factors have conspired to turn a levy on the rich into a nightmare for many in the middle class.

Nowhere are the inequities quite as dramatic as they are with people who run afoul of the AMT as a result of buying stock in the companies where they work. Roughly 15 million Americans now receive stock options-- rights to buy a company's shares at a set price in the future--as part of their pay packages. If you exercise stock options and hang onto your shares, there is no regular income tax due, because you have realized a profit on paper only. The investor will only receive a real profit if he sells those shares later for more than he paid. But AMT tax is levied on the paper profit, or the difference between the purchase price and the market price of the stock at the time of exercise.

Stock options were a part of Speltz's annual pay. Hoping to build a home in 1999, Speltz exercised his options but held onto the shares, at the urging of a tax expert who contended he

would save a fortune by holding the shares a year to get capital gains rates.

A year later, when the stock market had tanked and his company's stock was worth a fraction of what it was when he exercised his options, Speltz learned the horror of the AMT. He owes a tax of \$262,000 on shares that are now worth \$1,120.

The IRS is weighing a so-called "offer in compromise," a deal in which tax authorities agree to take less than what's due because the taxpayer has no hope of paying. But all Speltz has left to offer the government is roughly \$5,000 in a cash-value life insurance policy. In the meantime, his wife has gone back to work to try to pay down their escalating debt, and they're struggling just to keep their home.

Morin's story is similar. He held onto his company's stock after exercising options, never knowing about the AMT. He was able to realize an \$80,000 profit when he finally sold the stock, but his tax hit was nearly four times more--roughly \$300,000.

"We had no way to fathom how it was possible that we could be taxed \$300,000 on \$80,000 in gains," said Morin. "I don't have any other capital assets. I don't even have a car. We just have no hope of ever being able to pay this."

Morin and Speltz say they remain hopeful that the AMT will be reformed. A half-dozen bills were introduced in Congress last summer to do just that. However, none of them have made progress, partly due to the rapid evaporation of the federal budget surplus needed to pay for tax cuts.

Cost is a major reason why Congress has never repealed this tax, even though it has long been considered one of the most onerous aspects of the tax code. AMT now brings in upward of \$5 billion annually, Olson said.

She admits that fixing the AMT is no easy task. "The current system not only pulls in unintended targets, it doesn't capture all the intended taxpayers," Olson said. "I have been trying to think about how you would structure a replacement system, and I have to admit I haven't gotten very far. It is a very difficult issue."