

## Prisoners of the AMT

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**TAXES** | Unless Congress changes the law, the living hell visited upon these Iowa families could strike you, too. *By Mary Beth Franklin*

### PHOTOGRAPHS BY ETHAN HILL

**R**on and June Speltz seemed to be living the American dream. He had a good job. She was a stay-at-home mom with three beautiful young daughters. They lived frugally, paid their bills on time and bought land to build their dream house in Ely, Iowa, just outside of Cedar Rapids. In March 2000, at the height of the bull market, Ron exercised stock options for the first time since joining McLeodUSA in 1992 as one of the telecommunication company's first employees. The options, which gave him the right to purchase company stock for \$1 per share, were expiring, so he had to use them or lose them.

Ron, now 36, figured that someday he would sell the stock to pay for the new house, finance his daughters' education and fund his own retirement. His accountant advised him to hold the stock for at least a year so he could take advantage of the long-term capital-gains tax rate. Little did Ron know that his well-intentioned actions would buy him a one-way ticket to financial hell.

### WELCOME TO AMT-LAND

A year later, when the Speltzes were preparing their 2000 tax return, they learned just how much those "bargain" stock options really cost. Normally, income taxes are collected on the gain between the purchase price and the price when a stock is sold. But when it comes to incentive stock options--a form of compensation once reserved for corporate fat cats but commonly offered to high-tech employees during the boom years of the 1990s in lieu of bonuses or raises--a different set of rules apply. The alternative minimum tax, or AMT, counts the difference between the exercise price and the fair-market value as income even if the owner doesn't sell the stock. In other words, the paper profit is taxed. In Ron's case, the \$23-per-share difference on 36,000 options resulted in a tax bill of over \$263,000--more than three times his salary that year. In fact, the Speltzes' tax bill for 2000 was higher than George W. Bush's, even though the newly inaugurated President's taxable income was seven times larger.

Ron was far from alone. At least 120 employees of Cedar Rapids-based McLeodUSA were hit with huge tax bills for 2000, according to an informal e-mail survey conducted by an employee.

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Craig Hilgenberg, a manager at McLeod, was among those unexpectedly lassoed by the AMT. He sold all his stock, took out a second mortgage and borrowed from his 401(k) account to pay more than \$210,000 in federal and state taxes. "I lost everything to pay the tax," says Hilgenberg, 41, a father of four.

Ironically, if any of them had sold their stock in the same year they acquired it, the AMT would have left them alone. Although they would still have owed regular income taxes, they would have had an actual profit to pay the bill and would have benefited from all the deductions available under the regular rules--including write-offs for property taxes, state income taxes, miscellaneous itemized deductions and personal exemptions. None of those count in AMT-land. "We're telephone guys, not financial wizards," says Hilgenberg, noting that he and his fellow workers asked financial advisers for guidance and did as they were told. The advice to hang on to the stock for at least a year--in order to take advantage of the lower capital-gains rate--would have been astute if the share price had held steady or continued to increase. But the stock price collapsed, wiping out the profit but not the AMT bill.

None of those interviewed for this story blame McLeod-USA for their financial problems. Rather, they were thankful they'd had a chance to share in the company's short-lived prosperity before it slipped into bankruptcy in 2002. (The company, one of Cedar Rapids's major employers, continues to operate with a sharply reduced workforce.) But these workers are frustrated with their government and its convoluted tax laws, which have left many deep in debt and some, including the Speltzes, on the verge of bankruptcy.

"If I had the gain I was being taxed on, I would be more than happy to pay," says Ron. "But this is a tax on income we never had. The IRS didn't just take everything we had-- they stole our future."

## **A TICKING TIME BOMB**

While the Speltzes' case is an extreme example, many middle-class Americans will soon feel the sting of the AMT. Created more than 30 years ago to prevent the wealthy from gaming the system to pay little or no tax, the AMT now reaches decidedly into the ranks of the middle class. In 2000, 1.3 million taxpayers were subject to the AMT, a 30% increase from the year before. More than one-fourth of those taxpayers, like the Speltzes, had incomes of less than \$100,000. By 2010, one-third of all taxpayers will be stung by the AMT, projects the nonprofit Tax Policy Center. If left unchanged, by the end of the decade the AMT will affect virtually all married couples with two or more children and incomes between \$75,000 and \$200,000. Ironically, the recent round of tax cuts makes it more likely that you will be targeted.

To understand how the AMT works, forget everything you know about taxes. The AMT, quite simply, is an alternative way of doing things. For taxpayers, it means doing your taxes twice--once to figure your regular tax and once to calculate AMT. You pay whichever is higher. The AMT has its own set of tax brackets, but unlike the brackets in the regular tax code, they are not indexed for inflation and haven't been reduced in the recent rounds of tax cuts.

You don't have to exercise stock options to be affected by the AMT, either. Just live in a state with high income taxes, pay substantial property taxes or have a few kids and you could end up as AMT bait. At first glance, the AMT's top tax rate of 28% may seem less onerous than the regular income tax, which has a top bracket of 35%. But, as noted earlier, there's a catch: Many write-offs that Americans depend on to reduce their tax bill aren't allowed under the AMT.

One of the most vocal critics of the AMT is Nina Olson, the IRS's national taxpayer advocate. "Each year this becomes an issue for more and more taxpayers," says Olson. "Very soon, people are going to be preparing their tax returns and this weird Form 6521 is going to calculate their extra tax liability and they are going to be angry. Politically, that's not a good message to send to 33 million people."

She has repeatedly urged Congress to consider indexing the AMT income brackets to inflation or increasing the exemption amount so that the tax applies only to its original audience--the very wealthy. However, the longer Congress waits, the more expensive it becomes to fix the AMT. By 2010, the AMT will be bringing in more money than the regular income tax, according to the Tax Policy Center. But besides individuals like the Speltzes, and other participants in the grassroots ReformAMT organization ([www.reformamt.org](http://www.reformamt.org)) who have personally experienced the financial devastation of the stealth tax, few members of the public have complained about the

AMT or are even aware that it may be moving inexorably toward them.

Olson, who lives in the nation's capital, was shocked when she was nabbed by the AMT last year, boosting her tax bill by about \$720. "In the past, my campaign to fix the AMT was theoretical," Olson says. "Now it's personal."

Since the AMT on stock options is a prepayment on future gains, taxpayers can claim an AMT credit in subsequent years to offset their regular tax liability--presumably when they sell the shares for a real profit. But Olson concedes that the creators of the AMT seem not to have envisioned what would happen if those gains never materialized. Thanks to a limit on how much of the credit can be used in any one year, it could take decades for taxpayers like the Speltzes to recoup the tax on busted stock options.

## DEEP IN DEBT

While the Speltzes were stunned to learn in April 2001 that they owed \$263,000 in federal and state taxes, they forged ahead to find a way to pay their bills. Although the value of their McLeod stock had slipped to about \$6 a share, their banker and financial adviser said they would be crazy to sell it. It was sure to bounce back. So they wiped out their savings and borrowed \$134,000 to pay their \$47,000 Iowa tax bill in full, and made an \$87,000 down payment on their federal debt. That was on top of a \$300,000 construction loan they had taken out to build their dream house before they knew about their tax problems.

Soon afterward, the Speltzes were assigned to a local IRS collection agent to work out a payment schedule. After reviewing their finances, he told the couple that there was no way they could afford to pay off a debt of that size and recommended they enter into an "offer in compromise" with the IRS to settle for a lesser amount. The Speltzes were overjoyed. They prayed it would be the end of their nightmare. But it was just the beginning.

Meanwhile, construction continued on their new home. They cut back where they could, choosing less expensive materials for their kitchen countertops than the granite they had once envisioned and leaving a bare bulb in their entry foyer where a chandelier was to hang. They sold their modest home in Cedar Rapids, with the entire \$30,000 gain going to repay the bank that had made the loan to pay their taxes.

Meanwhile, they moved into the house that now seemed like an unaffordable extravagance. If they sold it, all the money would go to repaying the bank and the IRS, and they would have no place to live. "We're trapped in our dream house," says June, who took a part-time job at a local department store at night and on weekends to earn a little extra money. She goes to work after Ron gets home from his job. They can't afford day care for their children.

When the IRS contacted the couple about an offer in compromise, Ron offered the only thing of value he owned: an old life-insurance policy with a cash value of about \$5,000. The offer was rejected. The IRS agent told the Speltzes' tax attorney that the couple's previously spotless credit record and history of always paying their taxes suggested that the government could get more. He recommended that they pay \$2,366 a month for the next four years--a total of more than \$110,000. They appealed.

In May 2002 the Speltzes received a notice that the IRS planned to place a lien on their home for the remaining tax debt of nearly \$140,000, including penalties and interest. The IRS confiscated a \$16,000 refund on their 2001 taxes (due in part to the AMT credit), as it would claim their \$12,500 refund for the following tax year. This summer, the couple received a letter from the IRS announcing they would receive a \$1,200 check as an advance payment on the beefed-up child credit--which was followed a couple of days later by a letter saying that that money, too, was being diverted to pay the AMT bill.

They pleaded for help in letters to their congressman and senators. The responses were courteous but offered no hope. The Speltzes turned to the taxpayer advocate's office in Washington, D.C., but their request was bumped to a regional office that offered no help.

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An Iowa family lost \$34,500 on the stock options but was hit with an AMT bill on a huge phantom profit.

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When the Speltzes were interviewed in the summer, their only hope was to hang on until next April, when they could declare bankruptcy to wipe out the debt. (A federal tax bill must be at least three years old before it can be discharged.) But even that grim option looked doubtful because the bank announced that it would start garnishing Ron's wages by taking \$500 a month out of his paycheck to repay his loan.

"I don't know how we can squeeze out another penny," says June. Among the painful sacrifices they have had to make were taking their oldest daughter out of Catholic school and deciding that they could not afford to have a fourth child.

The Speltzes finally sold their McLeodUSA stock earlier this year for about \$1,500--\$34,500 less than what they paid and \$826,500 less than the value they were taxed on. They used the money to pay their tax attorney.

## **A GLIMMER OF HOPE**

After *Kiplinger's* contacted the National Taxpayer Advocate's office in Washington, D.C., Nina Olson agreed to review the Speltzes' situation. As we went to press, a specialist had been assigned to their case, but no decision had been made. Our calls to Sen. Chuck Grassley, who is not only one of the Speltzes' senators but also chairman of the Senate Committee on Finance, resulted in a letter to Olson's office urging her to take another look at the case. The letter suggested that it was well within the agency's authority to resolve the tax debt through an offer in compromise that would allow the family to make a smaller payment and forgive the rest of the debt.

"We're really hoping common sense will prevail," says June. "We just want this nightmare to end." ■

--Reporter: **ALISON STEVENSON**