SIGMA INVESTMENT COUNSELORS

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Beware the "Stealth Tax"

The alternative minimum tax (AMT) was originated in 1969 to prevent the super rich from using special tax benefits to pay little or no tax. But for various reasons the AMT has sneaked up on more and more people each year – hence the description "stealth tax" — including some middle class American taxpayers. Suddenly, some people's tax bills are much higher than expected. For the 2002 tax year, around 2.5 million taxpayers paid more because of the AMT. By 2005, unless the system is changed, the AMT may claim over 13 million victims and as many as 35 million plus by 2010.

The best way to think about the AMT is that it is a separate tax system from the regular tax method. It means that many taxpayers need to compute their income tax liability twice and essentially pay the higher of the two calculations.

Why is the number of AMT taxpayers accelerating?

■ The AMT provides a formula for computing tax that ignores certain preferential tax treatments and deductions that taxpayers would otherwise be entitled to claim. Only certain types of deductions and exemptions are magnets. For instance, the interest you deduct on your home mortgage will not push you into the AMT no matter how luxurious your home. However, deducting interest on a home equity line of credit that is not used for home improvements, will subject you to the AMT. While the AMT rate may be lower than standard income tax rates – 26% to 28% — the loss of deductions and exemptions will result in a higher tax bill.

■ The exemptions related to the AMT are not adjusted for inflation while the exemptions and standard deductions related to the regular tax calculation are adjusted annually for inflation. As a result many people whose income has grown while the exemptions and standard deductions related to the AMT have **not** grown because of no inflation adjustment will find they fall under the AMT provisions.

How will you know if you have entered the dreaded AMT tax zone? Unfortunately, there is no easy answer to this question. The only certain way is to calculate your tax using both methods.

What are the major items that can cause (or contribute to) liability under the alternative minimum tax? Following is an *incomplete list* but those items most likely to affect more people than other items:

■ Believe it or not, having large families because the more exemptions you have, the more likely you will have AMT liability. Generally, exemptions alone will not lead you to AMT liability, but they can be a contributing factor as they are not allowed for calculating the AMT.

■ Living in high-tax states like New York City or California. State and local taxes, including property taxes and state income taxes can be claimed as itemized deductions in calculating your regular tax. However, these deductions are not allowed under the AMT.

■ Exercising employee stock options. Generally, at the time you exercise an incentive stock option, you do not report anything on your regular tax. However, for purposes of the AMT, you have to report the difference between your exercise price and the fair market value of the stock on the exercise date as income in calculating the AMT.

■ Miscellaneous itemized deductions. Miscellaneous itemized deductions that are greater than 2% of your adjusted gross income are deductible for normal tax purposes, but they are **not** deductible in calculating the AMT. Among the items included in this category are

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investment fees, tax preparation fees, unreimbursed employee expenses, and many others too numerous to mention. Owners of partnerships, S corporations, and limited liability companies may end up in permanent AMT territory as these entities pass on business credits and depreciation to their personal tax returns that are not deductible for AMT purposes.

■ Medical expenses. The AMT allows a medical expense deduction but it must exceed 10% of adjusted gross income, compared to 7.5% for regular tax purposes.

■ Large long-term capital gains. Long-term capital gains receive the same preferential rate under the AMT as they do under the regular income tax. However, they can cause AMT liability. A major reason for paying AMT in the year of a large capital gain is the *AMT exemption*. This is a special deduction that's designed to prevent the alternative minimum tax from applying at lower income levels. The problem is that the AMT exemption is *phased out* when your income goes above a certain level. Capital gain is income, so it can reduce or eliminate your AMT exemption.

The exemption amounts are: $58,000 if you are married filing jointly or are a qualifying widow or widower; $40,250 if you're single or head of a household; and $29,000 if you're married filing separately. If your taxable income for AMT purposes exceeds the exemption amount, you will be subject to a 26% AMT rate on the first $175,000 over the exemption amount, and a 28% rate on any income above this $175,000 amount. The AMT exemption amounts are phased out for taxpayers exceeding specified income levels. Under these rules, exemption amounts are reduced by 25% of the amount by which an individual's income exceeds $150,000 in the case of joint filers and surviving spouses, $112,250 for single taxpayers, and $75,000 for married taxpayers filing separately. Further, the exemption available to married couples filing jointly is eliminated entirely if income exceeds $382,000, $273,500 for single individuals, and $191,000 for married taxpayers filing separately.

Let's look at an example. If you are single and your income under the AMT rules is $112,250 or less, you are allowed an AMT exemption of $40,250. Your AMT calculation would be your income minus the exemption times 26%. Let's say your income is $80,000. Then the calculation would be $80,000 - $40,250 = $39750 x 26% = $10,335. You would compare this to your calculation using the regular method and pay the higher tax of the two. Using the regular method, you can take one exemption of $3,050. Let's say you have deductions relating to a mortgage on a home, state and local taxes and charitable deductions totaling $9,600. Your adjusted gross income would be $67,350. Then your regular tax would be $13,346 or $80,000 - $3050 = $76,950 - $9,600 = $67,350 x an effective tax rate of 19.8% = $13,346. In this case, you would pay the regular tax.

Now let's suppose you realize a capital gain of $200,000 due to sale of a real estate investment, stock or perhaps sale of a business. Your tax on the capital gain is 15% under both the regular tax and the AMT: $30,000. But under the AMT, the added income wiped out your AMT exemption. How does this work? Your total income is $80,000 ordinary income plus $200,000 in capital gains equaling $280,000. The exemption allowed is reduced by 25% of the amount that income exceeds $112,500. Therefore, $280,000 - $112,500 = $167,750 x 25% = $41,937.50. This amount is greater than the normal $40,250 allowed if you only earned $80,000 so you are not entitled to any exemption on the $80,000 and that whole amount would be taxed at 26% or equal $20,800. Your total tax under this AMT calculation would be $30,000 capital gains plus $20,800 on your ordinary income for a total of $50,800. Your tax calculated the regular way would be $30,000 capital gains tax plus $13,346 on your ordinary income totaling $43,346. In this case, you would have to pay the higher AMT amount of $50,800.

Is there more that I need to know about the AMT? By now, you probably are already overwhelmed by the AMT. Perhaps the best advice you can glean from this Sigma Summary is that you may need to consult with a tax professional not only to understand whether you are subject to the AMT, but also, whether you might have an *AMT Credit* the following year. Further, you may wish some counseling before adhering to the traditional advice of prepaying such taxes as real estate or state and local taxes.

A portion of your AMT liability may be eligible to reduce the amount of tax you pay on future tax returns. Exercising stock options is one of the things that may qualify you for a credit.

As far as tax planning strategies are concerned, if you have such deductions that permanently trigger the AMT for you, generally you will be advised to do the opposite for AMT planning than you do for regular tax planning. Generally, for regular tax planning you would move deductions from next year to the current year and defer income from this year to next. If you are subject to the AMT on a permanent basis, however, you would do just the opposite. A tax professional can aid you in these decisions and also help you determine the optimum amount of income to accelerate, a calculation that is not easy to compute.

Clearly, the AMT is a very complicated subject. The goal of this Sigma Summary has been to help you identify the important issues that may determine your AMT status. In addition, we wanted you to be aware that you may need to do some strategic tax planning that may be quite different than you would have expected either to avoid the AMT or minimize it. Also, now is the time to contact your tax advisor to see if you are vulnerable to the AMT and to consider corrective actions. Finally, if any investment decisions are involved, you should be consulting with your tax advisor as well as your investment manager.

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