FPA FINANCIAL PLANNING PERSPECTIVES

Afraid of the AMT? Now's the Time to Get Some Help

Unless Congress acts, the number of taxpayers hit by the Alternative Minimum Tax (AMT) in 2007 will jump to about 23 million from about 4 million in 2006. The AMT is an alternative, separate tax calculation created in 1969 to make sure the wealthiest Americans paid a fair amount of taxes. The AMT is applied to particular taxpayers' regular taxable income when particular activities and deductions add up.

Basically, Uncle Sam wanted to keep taxpayers from writing off their tax responsibilities forever.

But why is the AMT spreading lower and lower on the tax rolls to the middle class? There are two reasons. First, since its introduction in 1969, elements of the AMT have not been adjusted for inflation while the regular income tax has. According to the Tax Policy Center of the Urban Institute, this means that if an individual's income tax just keeps up with the annual rate of inflation, his or her income tax would remain constant in real terms while the potential AMT liability would continue to increase. Second, it's also important to note that since its inception, the government has dropped the top tax rate from 70 percent at the start to 35 percent in this decade while the AMT rate has risen by several percentage points. The intersection of AMT and regular tax over the past 40 years is as much as story of changing tax brackets as it is the adjustment of the exemption amount.

The approaching election year might finally force some permanent change on the AMT situation, but until then, it makes sense to consult a qualified tax advisor or a Certified Financial Planner™ professional on your risk factors for the AMT. It's too complicated to fully explain here, so advice is essential. There are many reasons people get pushed into the AMT zone. Here are some key facts and situations related to the AMT:

Who should check for the AMT? If your income is above $75,000 and you write off personal exemptions, state income taxes, property taxes and home equity loan interest, it's best to see if you're at risk. And if you're simply earning over $100,000, you definitely should check for AMT eligibility no matter what your deduction status. Form 6251 requires you to add back some deductions and income exclusions to your regular taxable income in the process of computing AMT. Among them: Your personal- and dependent exemptions, or your standard deduction if you don't itemize. You will also lose your state local and foreign income and property tax write-offs and potentially your home equity loan interest if you don't use your home equity line for home improvements. Once computed, if the AMT is higher than your regular tax liability you pay the additional amount (in addition to regular taxes). The hit could be surprising.

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Watch those stock options: If you're thinking of exercising incentive stock options, keep an eye on the spread between the market value at the time of exercise and the exercise price. Although not immediately subject to regular tax, the spread is subject to AMT. Based on advice particular to your situation, you might want to keep those options still and not exercise them until early 2008 to gain some tax flexibility.

If you own a business, get advice: If you own a business, rental properties or hold an interest in a partnership or an S corporation, certain business depreciation deductions might be a critical trigger for the AMT lens.

Tax-free bonds can be a trigger: The AMT counts as income interest earned from municipal bonds designated as private activity bonds, so there goes that tax edge. Many tax-exempt money market funds and high-yield tax-exempt municipal bond funds may hold relatively large percentages of these bonds.

Know your AMT exemptions: For 2007, if Congress does not extend the act increasing the exemption (the so-called AMT "patch" legislation), the AMT exemption will be decreased to $33,750 for an individual, $45,000 if married filing jointly or if that person is a qualifying widow or widower and $22,500 if married filing separately. These exemptions were higher in 2006 after Congress came to the rescue. As of this year, the exemption for Hurricane Katrina victims is scheduled to expire as well as the additional exemption for taxpayers who provide housing for a person displaced by Hurricane Katrina.

More bad news: The following credits won't be allowed against the AMT unless Congress rides to the rescue: Child and dependent care expenses, credit for the elderly or the disabled, education credits, residential energy credits and the mortgage interest credit. Also, if you live in the District of Columbia, its first-time homebuyer credit will no longer be allowed against the AMT.

The key is to work with your advisors to determine if you are a likely target and include the AMT as part of the planning process. Often, it is more something to be aware of than to be avoided. Because the AMT is so complicated (and may complicate financial decisions), the IRS provides an *AMT Assistant for Individuals*—an electronic version of the AMT worksheet in the 1040 instructions—go to: http://www.irs.gov/businesses/small/article/0,,id=150703,00.html

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