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The Alternative Minimum Tax: A Tax Trap for the Unwary

An increasing number of taxpayers are getting caught by the Alternative Minimum Tax, and it's not necessarily because they're wealthy. Find out if you may be affected soon and what you can do about it.

It's tax time. You spend hours digging through receipts, organizing 1099s and W-2s, entering the data on your PC, and double checking your entries. Then you mail in your Form 1040, thinking that it's all over for another year – until you get a notice from the IRS claiming that you owe more taxes!

Did you make mistakes, misinterpret the law, take any questionable deductions, or engage in any tax avoidance “schemes?” No. You simply may be one of the many people who in the next few years will be subject to the Alternative Minimum Tax (AMT).

Originally designed to ensure that high income earners pay at least a minimum amount of tax by reducing the benefits of certain esoteric deductions, the AMT is no longer a tax on just the wealthy. Any single person with taxable income over \$44,000 a year (\$66,000 for joint filers) may be affected by the AMT. Nor is AMT liability solely triggered by investing in oil wells or exotic tax shelters. If you live or work in a high tax state, have a big family, incur high medical expenses, or take out a home equity loan, you could be affected by the AMT.

Why worry about the AMT?

The AMT is a separate tax computation. First, figure out your regular income tax as you've always done. Then, calculate your tax using the AMT's special rules and pay the higher of the two. While this may *sound* simple, the actual calculation on Form 6251 is so complicated that a former IRS commissioner has discouraged taxpayers from attempting to compute the tax themselves, even using computer software.

The problem with the AMT is not just its complexity: It is potentially costly. The AMT's rates are significantly lower than the rates under the regular income tax – but many common deductions and exemptions that you can use to reduce your regular income tax bill are disallowed when you compute your AMT. As a result, the tax base for the AMT can be much larger than for the regular income tax.

The tax trouble doesn't stop there. The AMT exemption amounts, which reduce the income subject to the AMT, are phased out as income rises; thus, your potential AMT liability increases with your income. In addition, unlike various components of the regular income tax that have been automatically indexed for inflation since 1985 (e.g., tax brackets, standard deductions, exemptions for dependents), Congress doesn't always index the AMT exemption amounts. And while Congress did increase the AMT exemption amounts for the 2007 tax year (\$44,350 for single filers and \$66,250 for joint filers), there is no assurance of similar increases going forward.

What's Not Allowed Under the AMT

Many familiar deductions and exemptions that reduce regular taxable income aren't allowed under the AMT. Here are some of the most common:

- Personal exemptions, claimed for yourself and your dependents
- The standard deduction, claimed if you don't itemize deductions
- Itemized deductions for state and local income taxes, real estate taxes, and personal property taxes
- Itemized deductions for home equity loan interest, unless the loan was used to buy, build, or substantially improve your home
- Itemized deductions for medical and dental expenses, unless they exceed 10% of your adjusted gross income
- Itemized miscellaneous deductions, such as those for tax preparation fees and unreimbursed employee business expenses (see more on this below)
- Gains on exercised incentive stock options
- Some types of tax-free municipal bond interest (see more on this below).

Keep in mind that taking advantage of these deductions and exemptions doesn't necessarily mean you'll be hit with the AMT.

How to Minimize AMT Liability

The key to minimizing AMT liability is meeting with a tax professional. It may make sense to have an initial meeting before year's end, and then additional sessions as necessary, especially if your income fluctuates. Here are some pointers for battling the AMT:

Combine Income With Deductions in the Same Year — The general rule for tax planning is to accelerate deductions and defer income. However, AMT planning can turn this rule on its head. Just as you might offset gains on stock sales by selling losers during the same year, reducing any AMT liability often requires *matching* income with deductions — even if that means taking income one year (from your retirement plans, for example) and deductions the next. In fact, boosting your income in years when you *know* you'll be subject to the AMT may make sense — because then you'll be in a maximum 28% tax bracket, instead of in a regular income tax bracket, currently as high as 35%, in a later year when you're not subject to the AMT.

On the other hand, taking more income in a given year may result in losing the benefit of the AMT exemption. That's why a tax professional must create various scenarios to determine which one provides the greatest tax savings.

Work as an independent contractor instead of an employee — If you are doing unsalaried work, consider whether you qualify as an independent contractor rather than as an employee. (For

more information on the distinction between employees and independent contractors, see IRS Publication 1779 at www.irs.gov.) Employees, as defined by the IRS, may deduct only those unreimbursed business expenses greater than 2% of adjusted gross income on Schedule A (Form 1040). Taxpayers categorized as independent contractors (instead of employees) do not have to meet the 2% threshold, and may deduct all eligible expenses on Schedule C (Form 1040). Also, unreimbursed employee business expenses deducted on Schedule A will be added back into income for the AMT calculation – but Schedule C expenses won't be added back. On the other hand, while Social Security taxes are split between employer and employee, independent contractors pay for the entire tax themselves. So again, you should consult a tax professional, to consider these trade-offs.

Choose municipal bonds and municipal bond funds carefully — Municipal bond interest is free from federal income taxes for regular income tax purposes. However, interest on private activity municipal bonds (used to finance projects such as airports or stadiums) issued after August 7, 1986, is fully taxable for AMT purposes.

One way to tell if a municipal bond fund's income is subject to the AMT is to check its name and read its prospectus. According to the Securities and Exchange Commission, a fund can't call itself "tax exempt" or "tax-free" if 20% or more of its income is subject to the AMT. So, if you invest in a municipal bond fund, the fund's income may be taxable under the AMT. Bonds subject to the AMT often have a slightly higher yield. However, that extra yield usually doesn't compensate taxpayers for any AMT liability.

The bottom line is that if you are subject to the AMT, your taxes will be more complicated and your accountant's bills will likely be higher than before. But the time and money spend with a knowledgeable professional can save you a lot of money and aggravation.

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