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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. You mail the Form 1040, thinking you're finished with the return, 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. Instead, you 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 \$42,000 a year (\$62,000 for joint-filers) may be affected by the AMT. Nor is AMT liability solely triggered by investing in oil wells or in 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. Although the AMT's rates are as much as 10 percentage points below regular rates, many common deductions used to reduce ordinary income taxes are disallowed when computing the AMT. (See "What's Not Allowed under the AMT?" at the end of the article.) As a result, the tax base for the AMT is generally 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 has only occasionally raised the AMT exemption amounts. In fact, AMT exemption amounts were *decreased* in 2005 for everyone, not just high earners. And while Congress did increase the AMT exemption amounts for the 2006 tax

year (\$42,500 for single-filers and \$62,500 for joint-filers), there is no assurance of similar increases going forward.

Plan to Reduce AMT Liability

The key to minimizing potential 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 in the AMT may make sense because you'll be in a (maximum) 28% tax bracket instead of a regular income tax bracket, currently as high as 35%.

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 nonsalaried 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 1179 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, Schedule A expenses are not allowed under the AMT, but Schedule C expenses are. On the other hand, while Social Security taxes are split between employer and employee, self-employed individuals pay for the entire tax.

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: 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 spent with a knowledgeable professional can save you a lot of money and aggravation.

What's Not Allowed Under the AMT?

Many write-offs that reduce regular taxable income aren't allowed under the AMT. Here are some of the most common. Keep in mind that taking advantage of these write-offs doesn't necessarily mean you'll be hit with the AMT.

Personal and dependency exemptions

Miscellaneous itemized deductions—Expenses such as tax preparation fees and unreimbursed employee expenses may be deducted on Schedule A for regular income tax purposes only if they exceed 2% of Adjusted Gross Income (AGI). These expenses are not permitted for AMT purposes.

State and local income and property taxes

Standard deduction—Most AMT victims are high-income earners (and, therefore, more likely to itemize deductions), so using the standard deduction generally does not thrust taxpayers into the AMT. However, under certain circumstances, a taxpayer claiming the standard deduction may be subject to AMT liability.

Certain mortgage interest—Interest on loans used to build, buy, or improve your principal residence is permitted under the AMT. Mortgage interest used for any other purpose—such as a home equity loan—is not allowed.

Gains on exercised incentive stock options—If you exercise a large incentive stock option, you may generate AMT liability.

Medical expenses—Although the threshold for deducting medical expenses under the regular income tax is 7.5% of AGI, medical expenses must exceed 10% of AGI in order to be deductible under the AMT.

Tax-free interest—As discussed above, certain municipal bonds and municipal bond funds pay interest that is free from federal income taxes but taxable under the AMT.

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