START PLANNING NOW TO AVOID DREADED ALTERNATIVE TAX

The dreaded alternative minimum tax may soon be coming to a tax return near you—perhaps your own. But don't wait until next spring, when it's too late, to find out whether you're subject to the AMT. Take steps now to minimize or avoid the impact of this tax.

Don't think you're vulnerable to this "rich man's tax"? If you live in a high-tax state, have large capital gains, exercise certain stock options, have a large family, pay a lot in investment fees, or itemize employee business expenses, among other things, you may soon be subject to the AMT.

The alternative minimum tax is a complicated parallel federal income tax system originally designed by Congress to ensure that ultra wealthy taxpayers, who sometimes escaped paying regular income tax through extensive deductions, paid their share. The concept is for taxpayers to calculate their tax the regular way and then recalculate it under the AMT by adding back certain deductions and adjustments. Whichever method results in the highest tax bill is the one the taxpayer must use.

For many years, AMT hit mostly higher-income taxpayers. But Congress has not adjusted the tax for inflation and other factors. Also, recent tax acts have subjected more people to AMT by lowering ordinary income tax rates versus AMT tax rates.

By 2010, estimates The Tax Policy Center, one in every three taxpayers may be paying the AMT instead of the regular income tax, and nearly one in four households earning between $50,000 and $75,000 will pay the alternative tax. The Congressional Budget Office estimates that 90 percent of married taxpayers with annual incomes of $100,000 to $500,000 will be paying AMT by 2010.

What can you do to escape or minimize the alternative minimum tax? The key is to sit down *now* with your financial planner or other tax advisor to identify where you are vulnerable and see what actions you can take. Don't wait until next spring when you are filing your 2004 taxes to find out if you owe AMT—or worse, fail to calculate for AMT at all and get dinged by the IRS for interest and penalties.

Here's a list of some of the most common items you can't deduct under AMT and what you may—or may not—be able to do about them:

State income or property taxes. This hits taxpayers hardest in high tax states such as California or New York. Adjusting the timing of your state income tax payments may help, but otherwise there's little you can do short of moving.

AMT taxes the spread between the exercise price of an **incentive stock option** and the stock price, even if the price declines before you sell the stock in a future year. But there are strategies for avoiding or minimizing the blow.

Interest from public-purpose **municipal bonds** remains free of AMT tax, but not the interest from private-purpose munis, such as those used to finance airports, sports stadiums, and industrial-development zones. Tax-exempt money market funds and high-yield municipal bond funds often hold relatively large positions in securities subject to AMT.

The personal **exemptions** you can take for yourself, your spouse, and each of your dependent children are not allowed under AMT—a real problem if you have a large family of dependents.

You can take the interest deduction on a **home equity loan** under AMT but only for that portion of the loan used to improve your home. The interest portion used to pay for such things as college or other consumer debts isn't deductible.

Also lost under AMT is the **miscellaneous itemized deduction**, subject to the two-percent floor. This category includes unreimbursed employee business expenses such as union dues, various investment expense deductions, casualty losses, and tax preparation fees.

Think you might be subject to AMT this year but not next year? Consider **reversing** the traditional tax advice of deferring income and accelerating deductible expenses.

High-income retirees who can't avoid AMT may actually find it beneficial to accelerate taxable income from retirement accounts because the top AMT tax rate (28 percent) is still lower than the top regular income tax rate.

Some AMT taxpayers may be able to use an **AMT credit** to offset ordinary income taxes in subsequent tax years where they don't pay AMT.

-30-

This column is produced by the Financial Planning Association, the membership organization for the financial planning community, and is provided by Bob Adams, a local member of the FPA.