The Alternative Minimum Tax

How investors can limit the impact of the AMT **Interviewed by Bridget McCrea**

Every year, an increasing number of Americans get a nasty surprise when it comes time to file the previous year's tax returns. Enacted in 1969, the Alternative Minimum Tax (AMT) was created to ensure that wealthy individuals and corporate taxpayers pay their fair share of federal income taxes.

Although the AMT has been around for years, until recently, it was largely relegated to high-income taxpayers who would otherwise have been able to reduce their obligations through deductions. In future years, it just might apply to you.

"An estimated 3.8 million Americans are expected to pay the AMT for 2005," says Todd A. Moll, chief investment officer at Provenance Wealth Advisors in Fort Lauderdale. "But because of inflation adjustments and tax legislation enacted in 2001, more individuals — an estimated 20.5 million by 2007 — will be subject to the AMT."

Smart Business spoke with Moll about the AMT, steps that investors can take to minimize the impact of this tax and several investment options geared to limiting AMT exposure.

Todd A. Moll, CFA, CFP
Chief investment officer
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Why should investors consider the impact of the AMT right now?

The AMT was enacted 36 years ago with the intent of catching wealthy taxpayers who were using myriad deductions to avoid paying income taxes. Knowing this, the IRS and Congress created this minimum tax to ensure that investors paid some tax, regardless of their income level.

However, the AMT isn't indexed for inflation, which means its exemptions and levels have remained unchanged since the tax was instituted. Now, thanks to inflation, more and more people will be subject to the tax.

Many people whose income has grown with the economy enter the dreaded AMT zone each year. Especially vulnerable are people with income over $75,000 with large deductions, but not the unusual ones who were originally targeted by the AMT's creators. Most vulnerable are taxpayers with many children, interest deductions from second mortgages, capital gains, high state and local taxes, and incentive stock options.

What are some events/issues that can trigger the AMT?

The AMT has its own set of forms, rates, rules and brackets, and requires taxpayers to calculate their federal income tax using this alternative tax system. It is like an entirely separate tax code. Events that trigger it include substantial deductions claimed for (1) state income taxes, (2) dependent exemptions and (3) interest on home equity loans used for purposes other than home improvement. Normal exemptions or normal deductions on your regular tax bill are disallowed on AMT calculations.

Also, earning significant interest income (usually tax-exempt) from certain private-activity municipal bonds or exercising incentive stock options that are deep in the money (on which gain is usually deferrable and taxed as capital gain income) can trigger AMT.

How can investors minimize the potential for AMT?

Discuss with your tax professional in advance to see if you might be subject to the AMT. At the beginning of the year you'll want to do some pre-planning, run your tax calculations and make some assumptions based on whether or not your financial situation may cause you to fall into the trap of the AMT.

Are there any investment vehicles that are specifically geared toward investors with AMT exposure?

Because the AMT is affecting more and more Americans, the investment industry has begun creating mutual funds and investment vehicles specifically designed for taxpayers who are subject to the AMT. Many municipal bond funds are geared specifically to investors who are subject to the AMT.

Of course, before you choose any investment, read the prospectus carefully to make sure it is appropriate for your situation.

Also, investors should be cautious of auction rate-preferred securities, which act as the leveraging component of closed-end mutual funds. The closed-end funds borrow money from the investing public and use the borrowings to buy more bonds within the funds to increase the rate of return through the use of leverage.

Short-term in nature, these investments carry the same tax consequences of the underlying closed-end fund, which often holds bonds whose interest is subject to AMT.

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