

The AMT: Pitfalls and Solutions

by Cal Brown, CFP®

Executive Summary

- The alternative minimum tax is affecting an increasing number of people, particularly those with annual incomes between \$150,000 and \$500,000. Consequently, financial advisors need to be conversant with the details of the AMT.
- Advisors need to be especially alert to the AMT for clients who have modest incomes and a large number of children, take the standard deduction, live in a high-tax state, or have large capital gains, incentive stock options, and private activity bonds.
- Clients, such as retirees who no longer claim itemized deductions, may be vulnerable because they can't take the standard deduction in AMT. Clients in high-tax states may want to consider timing any estimated state-tax payments or moving to another state.
- Planners should caution clients that interest for home equity loans and lines of credit not used to buy, build, or improve a residence is not deductible under the AMT.
- While capital gains receive the same reduced rates under the AMT as they do the regular tax return, the AMT can still be triggered if the capital gains are large enough because the AMT exemption phases out.
- Incentive stock options are particularly complex for the AMT. The exercise of an ISO can create an the AMT liability if the stock is held at least 12 months following its exercise. Advisors may need to consider a "disqualifying disposition" of the stock so that it does not qualify for long-term capital gains treatment.
- Interest from private-activity bonds is a preference item under the AMT, so be cautious when recommending municipal-bond funds where a portion of the portfolio might be AMT bonds.

Cal Brown, CFP®, is vice president of financial planning of The Monitor Group Inc., a McLean, Virginia, investment advisory firm serving more than 200 client families with approximately \$300 million under management.

Most financial planners are aware of the alternative minimum tax. Yet, unless they are tax experts, many cannot articulate the algorithm for calculating the AMT or propose viable solutions for clients subject to it. Unfortunately, more taxpayers are becoming subject to the AMT every year. This article will focus on the aspects of the AMT that affect the non-corporate taxpayer; however, trusts and estates are similar to individuals in AMT treatment, and readers will find ways to apply what they learn here to these situations. This article points out areas of potential trouble for clients and offers solutions where possible. As the AMT certainly will be amended in the future, planners should stay tuned for news.

Although it was never intended to hit the middle class, AMT is doing just that today. Until 1996, the AMT affected less than one-half of 1 percent of all individual tax returns. In 2000 this doubled to 1 percent. It more than doubled again in 2002 to 2.3 percent, and is projected to double once more in 2005 to 4.6 percent.¹ According to the Joint Committee on Taxation in 2001, there will be 11.3 million taxpayers subject to the alternative minimum tax in 2005, versus 2.4 million in 2003, though the extension of the higher AMT exemption amount by Congress in 2004 may keep the numbers down a little longer.²

Why are millions of middle-class Americans being hit with the AMT? It is due to the disallowance of some common deductions and certain "preference items." Preference items are a targeted group of tax deductions and exemptions Congress decided would give wealthy taxpayers an advantage over their lower-income counterparts. High-income taxpayers do tend to have greater opportunities to take advantage of the many tax-saving items in the U.S. Tax Code. Yet individuals with the highest incomes are not affected by the AMT. Why? Because the maximum marginal rate (35 percent) for high-income taxpayers exceeds the maximum AMT rate (28 percent). Thus, if much of their taxable income is in the highest brackets, they will not pay the AMT. Both situations are discussed below.

Stealth Tax

The AMT is considered a "stealth" tax because it affects millions of unsuspecting middle-class taxpayers.³ The AMT now falls hardest on those with incomes from \$147,000 to \$373,000, according to Citizens for Tax Justice.⁴ Particularly vulnerable are taxpayers who claim several children, interest deductions from home equity loans or lines of credit, high state and local income taxes, or incentive stock options. Moreover, do-it-yourself taxpayers, especially those who do not use tax software, may not realize they are subject to the AMT or may calculate it incorrectly, and could end up owing interest and penalties should the oversight be discovered later through an audit.⁵

For example, in a 1998 case, a single retiree with adjusted gross income of \$49,379 had itemized deductions of \$33,002 that included \$30,972 in legal expenses and real estate taxes. The court ruled he was subject to the AMT and liable for a deficiency of \$1,675. He argued the AMT was intended to apply only to wealthy taxpayers, but the court could not disregard the statutory provisions of the Internal Revenue Code.⁶

Taxpayers in the highest bracket—those with taxable income exceeding \$319,100 (for tax year 2004)—are currently subject to a marginal rate of 35 percent, which is greater than the 28 percent maximum AMT rate. Even though the AMT exemption is phased out at that level, the AMT usually does not apply to very wealthy, high-income taxpayers. So, despite the original intent, the AMT primarily hits middle-income people and not the very wealthy.

Perhaps the best way for planners to learn about the AMT is to prepare tax returns themselves in which there is AMT liability. At a minimum, planners should carefully examine clients' returns containing a completed Form 6251, "Alternative Minimum Tax." Because so many items create AMT exposure, planners should study a number of different returns with AMT liability. An analysis of Form 6251 reveals that the AMT is calculated by simply adding back certain tax deductions and income exclusions to taxable income—this equals AMTI (alternative minimum taxable income)—then deducting the AMT exemption and applying the 26 percent and 28 percent tax rates, less any credits (see Figure 1).



What are the adjustments and preference items that can trigger the AMT? There are several:

1. Numerous personal and dependent exemptions, such as many kids
2. For non-itemizers, the standard deduction is disallowed

The following apply only to those who itemize deductions:

3. State (and local) income taxes
4. Home equity loans and lines of credit, if not used for home improvement
5. Medical expenses must exceed 10 percent of AGI, rather than 7.5 percent
6. Miscellaneous itemized deductions are not allowed

These apply to all tax returns:

7. Large capital gains can cause the AMT exemption to phase out
8. The bargain element of incentive stock options (ISOs)
9. Municipal bond interest from "private activity" bonds
10. Various tax credits
11. Various tax shelters, such as oil and gas depletion allowance
12. Business items, such as accelerated depreciation

The only itemized deductions from Schedule A that do not affect the AMT are charitable contributions and mortgage interest to buy, build, or improve a personal residence.

We will examine several of these in more detail. For some, planning strategies are available; for others, nothing can be done. Clients should be made aware of their AMT situation and advised of potential actions that could ameliorate it, if any. Clients preparing their own returns should use good tax software, but probably need professional help.

Personal Exemptions

In *Klaassen v. Commissioner*, TC Memo 1998-241, the court decided that the AMT applies to large families of modest income. The Klaassens had ten children and, on their 1994 return, they reported income of \$83,056, claimed 12 personal and dependency exemptions, and had itemized deductions including \$4,767 of medical expenses and \$3,264 in state and local income taxes.

The Internal Revenue Service audited their return and determined they were subject to the AMT, plus penalties and interest. The IRS determined that their AMT taxable income was \$68,832 (as opposed to their reported taxable income of \$34,092). The Klaassens did not challenge the IRS' calculations. Rather, they argued that Congress violated their religious freedom to have a large family. The Klaassens, members of the Reformed Presbyterian Church, believed having many children was a blessing of the Lord. Blessing or not, it does not exempt one from the AMT. The Klaassens lost.⁷

Planning strategy: Advisors must be aware that clients with modest incomes and large families may get hit by the AMT. If this situation exists, the advisor should notify the client that Form 6251 must be completed and the AMT tax paid. The planner should also examine whether older children with earned income should file their own tax returns and claim themselves as a personal exemption, if the children provide at least 50 percent of their own support.

Standard Deduction

In the AMT calculation, there is no standard deduction. As older taxpayers pay off their mortgages and have fewer itemized deductions, especially in states with no income tax, they revert to the standard deduction, and this may trigger the AMT. This is especially true if other items unrelated to itemized deductions exist, such as private-activity municipal bond interest.

State and Local Income Taxes

Clients who reside in high-tax states may have an AMT issue. Along with the personal exemptions problem, disallowing the deduction for state and local income taxes generates severe complaints against the AMT system. These items are not "loopholes" used by high-income individuals to avoid paying taxes. Nevertheless, until the law is changed, advisors in high-tax states (or with clients living in such states) must be aware of this potential AMT issue, and carefully check returns.

A little bit of good news: If the taxpayer received a refund of state income taxes, it is reportable on the regular tax return as income; however, it is not income on the AMT calculation, because the deduction was already excluded.

Planning strategy: If state income taxes are high, the client has several choices. First, move to a lower or zero income-tax state. Many clients have made this decision in retirement; it is not that far-fetched. Of course, states get their revenues in other ways, such as Florida's "intangible tax" on non-retirement investment assets. The planner can easily calculate the results using state-specific tax software. Before making a recommendation, the advisor should examine the entire picture.

Second, if the client is making estimated state-tax payments, it is possible to time the last payment. In non-AMT years, clients may be advised to make the January estimated state-tax payment in December, in order to claim that amount in the current tax year. But if the AMT is a problem, they should make the last payment in January. Also, by planning early in the year, they could postpone some or all of the quarterly estimated tax payments, reducing the state taxes paid in the AMT year. This will probably cause penalties to accrue, but the advisor can analyze whether the AMT savings outweigh the penalties. Timing decisions such as this generally make sense when the AMT liability is a one-time event, as opposed to a continuing problem.

Mortgage Interest—Home Equity Loans and Lines of Credit

Mortgage interest is subject to the AMT if the loan is not used to buy, build, or improve a residence. Thus, clients using the equity in their homes for other reasons, such as buying a car, or paying college expenses, may incur the AMT.

With current interest rates at low levels not seen since World War II, home equity loans and lines of credit are ubiquitous. Thus, more and more borrowers may be unwittingly creating an AMT liability.

Planning strategy: Do not assume all mortgage interest is 100 percent tax deductible. Document the purpose if the loan is to buy, build, or improve the property. If a high-income client has home equity loans or lines of credit causing AMT liability, one simple solution is to pay off the loan. But the advisor must consider the arbitrage between the long-term expected returns in the diversified portfolio versus the after-tax cost of the loan.

Medical Expenses

Medical expenses are allowed as a deduction under the AMT, but they must exceed 10 percent of AGI, rather than 7.5 percent as on the regular tax return. Usually, medical expenses will not trigger the AMT, but they can aggravate the problem if other preference items are present.

Miscellaneous Deductions

The U.S. Tax Court ruled that a taxpayer receiving punitive damages subject to the AMT could not deduct for AMT purposes the contingent legal fees paid to their attorney for obtaining the punitive damages. The mechanical application of the AMT rules required disallowance of the legal fees as a miscellaneous itemized deduction even though it was arguably unfair to tax the punitive damages and at the same time disallow expenses incurred in generating that income.⁸

In a similar case, James Sinyard, a division manager of IDS Financial Services in Mobile, Alabama, successfully sued IDS for age discrimination. He received \$547,146 in the settlement, and deducted \$252,608 in attorney's fees, reduced by 2 percent of AGI, leaving a deduction of \$240,984. This deduction could not be taken because he was subject to the AMT, which disallows miscellaneous deductions. The net effect is that the \$252,608 paid by Sinyard was treated as income to him.⁹

Advisors working with high-income clients on a fee basis routinely tell their clients the fees are deductible, subject to the 2 percent of AGI limitation. Because miscellaneous deductions are not allowed under the AMT calculation, advisors' fees may increase AMT liability.

Capital Gains and Dividends

Large realized capital gains and dividends may affect the AMT. In the 1978 act creating the AMT, it applied to capital gains for certain taxpayers. Today, however, capital gains receive the same reduced rates under the AMT as they do on the regular tax return.

Nevertheless, the AMT can be triggered by large capital gains because they increase adjusted gross income, and at certain levels of income (\$382,000 for married couples, \$273,500 for singles) the AMT exemption is phased out. The phaseout begins at \$150,000 for those who are married and filing jointly, and at \$112,500 for singles. Also, large capital gains will increase state income taxes, an AMT issue explained above.

For example, if AGI is \$150,000 but the client realizes a capital gain of \$250,000, he could have a larger tax liability than expected. The capital gains tax rate under both the regular tax and the AMT is 15 percent. But the additional income eliminates the AMT exemption and increases state income taxes. Assuming no other factors, this capital gain could result in the AMT being higher than the regular tax.

Worse yet, generally the AMT credit (discussed below) will not be available in future years because capital gains are not considered "timing items." Thus, the additional AMT caused by large capital gains is just a dead loss.¹⁰

Regarding the new 15 percent rate on qualified dividend income, the tax rate under the AMT calculation is also 15 percent. Thus, if everything else on the return is the same, the overall tax under both calculations will be lower than in 2002. If a person was paying the AMT in 2002, he or she would probably still be paying the AMT in 2003, but the total tax would be less. But if that person is in the AMT exemption phaseout range, each additional \$1 in dividends (or capital gains) will add \$1.25 to AMT income, increasing the effective tax to somewhat greater than 15 percent.¹¹ To assess the situation and develop a planning recommendation, the planner must run the numbers through professional tax software.

Planning strategy: It may be possible to time significant long-term capital gains. As the end of the calendar year approaches, timing decisions may be easier to make. A portion of the gain can be captured in the current year, and the remainder in the next year; or the gain could be spread over three or more years. But the risk of a decline in market value may exceed the AMT cost. The advisor should do an AMT calculation so the dollar value of the AMT liability caused by the capital gain is known.

Incentive Stock Options

Stock options, once considered a blessing, have become a horror story for many. As Sandra Block of *USA Today* wrote, "You've entered the AMT Zone, a parallel tax universe that's much scarier than anything you used to watch on black-and-white TV."¹²

After the 2000–2002 bear market, many employees' stock options became worthless. But there are many unexpired incentive stock options just waiting for the company stock to rise once again. Advisors should be prepared with proper tools to evaluate ISOs and the wisdom to give good advice. A significant portion of that advice relates to the AMT. There is no AMT issue with nonqualified stock options (NQSOs), unless an employee's income is pushed into the AMT zone because of cashing in options.

The exercise of an ISO may create AMT liability because the bargain element, the difference between the strike price and the market price on the day of exercise, can be an AMT preference item if the stock is held at least 12 months following exercise.¹³ If the stock is held for a year or more after exercise and subsequently sold, any profit qualifies for long-term capital gains treatment. As mentioned above, large capital gains can cause their own AMT problems. But unless the stock is sold within the same calendar year in which the ISOs are exercised, there will be an AMT issue.

Where there is AMT liability due to exercise of ISOs, an AMT credit is available in subsequent years.¹⁴ A taxpayer can only use the AMT credit in a year when he or she is not paying the AMT. The additional AMT liability can thus be recouped, but the time value of those dollars is lost.

Many tragic stories persist of employees who exercised ISOs at the height of the stock market bubble, then held the stock for a year to take advantage of the capital gains strategy. Advisors frequently encouraged this. The stock price subsequently fell dramatically and the stock was worth much less than the price at which it was bought (exercised). Unfortunately, the employee was liable for a massive AMT amount. In many cases, the AMT liability was so large that people lost their homes or had to declare bankruptcy.

The decision to exercise and dispose of ISOs is both an investment decision and a tax decision. An individual stock is much more volatile than a diversified portfolio of equities. Quantifying a future loss or gain in the market value of an individual stock is difficult, if not impossible.

It is not always the wise choice to hold stock acquired from exercising ISOs for 12 months or longer. It may be better to sell the stock much sooner, such as when the price of the stock is dropping, or if there is an emergency need for cash. There are actually three sale situations that are "disqualifying dispositions." A disqualifying disposition means the sale of the stock will not qualify for long-term capital gains treatment. The three situations are:

1. The stock is sold immediately after exercising.
2. The stock is sold within the same calendar year.
3. The stock is sold in the following calendar year, but less than 12 months after exercise.

Prudent use of a disqualifying disposition can avoid catastrophes, such as the following: The absolute worst-case scenario is when the stock plummets during the holding period, as it did for many high-tech employees in 2000, 2001, and 2002. For example, take an executive with incentive stock options whose strike price is \$500,000 but whose market price has tripled to \$1.5 million. Under the AMT, the \$1 million bargain element would result in a tax of \$280,000. But instead of dropping to a point still above the strike price, the price drops precipitously and the stock becomes worthless, or too low to sell (emotionally). The client is unaware that a disqualifying disposition would negate the AMT. Thus, the stock is not sold and there is no AMT credit. In this tragic case, the executive experiences a double-whammy: the out-of-pocket cost to exercise the ISOs (\$500,000) and the AMT tax (\$280,000). Make that a triple- or quadruple-whammy, since the stock is worthless and the executive is out of a job. Can it get any worse? Yes—the executive borrowed the \$500,000 to exercise the ISOs and now cannot repay.

An excellent article appeared in the [August 2001](#) issue of the *Journal of Financial Planning*, titled "Employee Stock Options: Using Monte Carlo Simulation to Create Exercise Strategies."¹⁵ In this article, the author,

Sreenivasan Srikanth, CFA, compared linear analysis to a probabilistic approach. Recognizing the difficulty of assumptions and input variables, he showed how conclusions regarding the exercise decision will be radically different based on a linear analysis versus a Monte Carlo analysis.

The linear analysis generally advocates a delayed exercise, because the stock price is always assumed to increase and thus the tax is deferred until the latest possible date. This leads to only one possible result: the highest after-tax value. The outcome is also affected by the assumed return of the company stock versus the diversified portfolio alternative; if the company stock is assumed to appreciate at a greater rate than the diversified portfolio, the software will indicate that exercising should be delayed.

When volatility is introduced in the stochastic model, a very different conclusion is reached. Early exercise and diversifying away the risk is advocated. The author states, "It would be easy to conclude from the linear analysis that a delayed exercise is clearly the superior strategy for the examined option. The probability analysis offers a more detailed insight and suggests it is inappropriate to make that conclusion. The results suggest that early exercise seems to be the better strategy, when the option holder seeks high levels of certainty (80 to 90 percent level) for the final result. Delayed exercise is capable of providing higher rewards, but the chances of attaining them are much lower."

The article pointed out another advantage—evaluating price spikes. If the company price rises to a level that the analysis has shown to have a very low probability, it may be a strong indicator to go ahead and exercise, taking advantage of a temporary situation.

If the client is presented with a range of possible outcomes, the conclusion may change. For example, if the "wait to exercise, then hold" strategy has a large spread between potential ending asset values, then it can properly be seen as very risky. On the other hand, if an "exercise immediately, and sell" strategy has a narrower range—a lower maximum potential value, but a higher minimum—the client may decide this is a more prudent, conservative strategy.

To summarize, a deterministic mean-only analysis leads to decisions that are aggressive and high risk, whereas a stochastic analysis leads to more conservative decisions with proper risk awareness.

Planning strategy: One key element of advice for any employee pursuing the long-term capital gains strategy with ISOs is to exercise the options in January. In late December, check the stock price—if the employee has an unrealized loss, go ahead and sell the stock as a disqualifying disposition. This will ensure that the ISO exercise is not subject to the AMT (because it was held for less than a year) and the client can avoid the tragic consequences discovered the hard way by so many employees. If the stock price has risen, then wait another month for the long-term capital gain.

Another conservative strategy would be to sell enough of the shares after exercising to generate cash to cover the AMT liability; this way a client would never owe the IRS money he or she did not have.¹⁶ The AMT amount could be recovered the following year via the AMT credit.

Also, stochastic analysis may indicate it is preferable to exercise options and sell early, rather than holding until the last possible moment. With a tremendous sum of money at stake, a less aggressive approach will avoid huge losses. Reason should prevail over unreasonable expectations; diversify the risk to preserve capital.

Finally, if AMT is owed, remember to recoup it in a subsequent year by using the AMT credit.

Municipal Bonds—When Tax-Free Becomes Taxable

Subsequent to the Tax Reform Act of 1986 (TRA '86), a legal opinion is required on every new issue of a

municipal bond stating whether it is subject to the AMT; that opinion is printed on the cover of the bond's offering statement.

TRA '86 mandated that municipal bonds be classified into one of two categories: public and private purpose. Interest received from private-purpose bonds is an AMT preference item. What are private-purpose bonds? They are used to finance projects such as airports, stadiums, housing, student loans, and industrial projects. Interest income from this type of bond, supposedly tax-exempt, can be taxed at the highest AMT rate of 28 percent.

It is easy to ascertain whether individual bonds are private-purpose (AMT) bonds. The difficulty arises with municipal bond mutual funds, as a portion of the portfolio may be composed of AMT bonds. The fund is required to issue a tax information brochure to explain the data. Morningstar requests this information from muni-bond funds, but not all funds supply it. For this reason, the advisor should exercise caution when recommending muni-bond funds.

Planning strategy: The delta between the higher interest paid by AMT bonds versus public-purpose bonds is generally only 10 to 20 basis points, so the AMT cost can be compared with the higher yield. An analysis may show it makes sense to eliminate AMT bonds from the portfolio. Potential AMT taxpayers should avoid bond funds with a high proportion of AMT bonds; anything above 20 percent is unacceptable.¹⁷ Several mutual fund companies are now offering AMT-free muni-bond funds.¹⁸

Tax Credits

Many of the credits allowed on the regular income-tax calculation are not allowed under the AMT. The more credits claimed, the more likely a taxpayer will owe AMT. Under the 2001 tax cut (Economic Growth and Tax Relief Reconciliation Act of 2001), taxpayers subject to the AMT may permanently claim the child-tax credit and the adoption-tax credit. But the popular education and child-care credits are no longer allowed against the AMT.

Additional Planning Strategies

AMT strategies may be diametrically opposed to traditional tax planning. For example, if a taxpayer will not be subject to the AMT persistently, but the AMT is triggered by a one-time event (large capital gains or an exercise of options), the taxpayer should push itemized deductions into a non-AMT year. In normal tax planning, a taxpayer should accelerate deductions and defer income. But when the client incurs the AMT, he or she should accelerate other income into that year (maximum tax rate of 28 percent) and defer deductions. But beware of the AMT exemption phaseout.¹⁹ Once again, the advisor should analyze in advance various scenarios so timing decisions can be made.

Conclusions and Summary

The alternative minimum tax affects more taxpayers each year. Questionable adjustments, such as dependency exemptions and state income taxes, along with the lack of indexing in the AMT calculation, are primary culprits. It is quite likely Congress will amend provisions of the AMT in coming years. But it is not politically attractive to perform a sweeping overhaul, because the AMT is generally understood to apply to the wealthy.

Financial advisors should be alert to changes in the AMT. In addition, planners should be very familiar with it and know how to plan to minimize clients' AMT liability. This article provides a starting point for that understanding.

Endnotes

1. Joint Economic Committee, U.S. Congress, Jim Saxton, Chairman, "The Alternative Minimum Tax for Individuals: A Growing Burden," May 2001: 3.
2. *Journal of Financial Planning*, "The Observer," [September 2003](#): 23.
3. David Cay Johnston, "A 'Stealth Tax' Is Creeping Up On Growing Numbers of Americans," *New York Times*, February 17, 2002.
4. Josh Gonze, "To Avoid AMT, Check Municipal Bond Funds' AMT Exposure," *Journal of Financial Planning* Web site, Between the Issues, www.journalfp.net, November 15, 2001.
5. Sandra Block, "Alternative Minimum Tax Is Nipping at Middle-Class Heels," *USA Today*, February 24, 2003.
6. *Holly v. Commissioner*, 75 TCM 1752, Dec. 52,564(M), TC Memo. 1998-55.
7. Michael Lynch, "Middle Class Family Falls Victim to AMT," *Journal of Accountancy*, November 1998.
8. *I. F. Benci-Woodward v. Commissioner*, CA-9, 2000-2 USTC ¶150,595, aff'g, 76 TCM 787, Dec. 52,944(M), TC Memo. 1998-395, cert. denied.
9. *Sinyard v. Commissioner*, 268 F.3d 756 (9th Cir.2001), 576.
10. Kaye Thomas, "AMT and Long-Term Capital Gains," *Fairmark Press Tax Guide for Investors*, Fairmark.com, December 20, 1999.
11. Amy Feldman, "The Tax of Unintended Consequences," *Money*, September 2003: 89.
12. Sandra Block, op. cit.
13. IRC Section 56(b)(3).
14. IRC Section 55(b)(1).
15. Sreenivasan Srikanth, CFA, "Employee Stock Options: Using Monte Carlo Simulation to Create Exercise Strategies," *Journal of Financial Planning*, [August 2001](#): 92-98.
16. Amy Feldman, op. cit.
17. Josh Gonze, op. cit.
18. Albert Crenshaw, *Washington Post*, February 15, 2004: 2.
19. Amy Feldman, op. cit.