

exemption for municipal bond interest. For example, in early June of this year the “taxable equivalent” yield on an AAA rated 10-year municipal bond was 4.60% for a 35% regular taxpayer, compared to 4.15% for a 28% AMT taxpayer. Both of these yields beat the 4.10% yield on a 10-year Treasury. Depending upon interest rate spreads, at other times the AMT taxpayer might find that the municipal bond is less attractive than the taxable bond. Investors considering municipal bonds also should note that certain municipal bonds referred to as “private activity bonds” usually will not be advisable because the interest on these bonds is taxable for AMT purposes.

As discussed above, charitable contributions continue to be deductible for AMT purposes. Therefore, the full array of philanthropic planning remains available for the AMT taxpayer. The prospective donor should remember, however, that the tax benefit of any deduction will be less under the AMT.

A final point to note concerns borrowing. In this era of tremendous appreciation in real estate values and historically low interest rates, many people are drawing on home equity lines of credit for purposes other than improving their home. Individuals considering such borrowing should be aware that, although the interest may be deductible for regular tax purposes, it will not be for AMT purposes. This AMT disadvantage also could apply to the future payment of interest on a reverse mortgage used to finance the costs of support and maintenance for an elderly person.

## Conclusion

The AMT increases individuals’ federal tax burdens and greatly complicates their record-keeping, tax return preparation, and tax planning. In many instances it becomes necessary to model an individual’s tax return to evaluate the effectiveness of planning ideas like the ones discussed in this *Perspective*. Our hope is that Congress will take appropriate action soon to address the not so alternative and not so minimum consequences of the AMT.



The *Perspective* is a Fiduciary Trust publication in which its professionals share their best thinking on timely investment and financial topics. This commentary was authored by **Robert G. Holdway**, Vice President and Investment Officer, who

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## Fiduciary Perspective

Summer 2005

### The Alternative Minimum Tax: Not So Alternative and Not So Minimum

#### Introduction

For many years the alternative minimum tax (“AMT”) was irrelevant to most people and received little attention. It affected only high-income individuals who engaged in certain transactions or who took advantage of other provisions in the law to reduce their income taxes significantly.

Today the AMT applies to an expanding cross-section of individuals and has become a hot topic. For example, if you perform a Google search using the term “alternative minimum tax” you will get about 5 million hits! Most high-income individuals, and many having lesser incomes, are becoming subject to the AMT even though they have not engaged in the kind of planning that the tax was originally intended to limit. Congress is wrestling with the AMT and may or may not provide legislative relief. In the meantime, it is important for our clients and friends to understand the potential financial impact of the AMT and how it might affect their income tax planning.

#### Evolution of the AMT

The predecessor of today’s AMT was enacted in 1969. It was a response to publicity about a small number of ultra-high-income individuals who were able to achieve the ultimate in

tax planning – zero tax. This publicity triggered a firestorm of protest about the unfairness of the income tax law. The depth of the public outrage is indicated by the fact that in 1969 the number of people who wrote to Congress to complain about wealthy individuals paying zero tax exceeded the number who wrote about the war in Vietnam.<sup>1</sup>

Over the years Congress has changed the structure, rates, and exemption levels of the AMT a number of times. In its current form, the AMT requires a separate tax calculation that parallels the calculation of the “regular” income tax. In determining taxable income for AMT purposes, regular taxable income is increased to reflect special treatment for certain deductions, exemptions, and “tax preference items.” The AMT disallows or reduces deductions for certain expenses that are commonly incurred by individuals, including state and local taxes, medical costs, investment management fees, and tax return preparation fees.

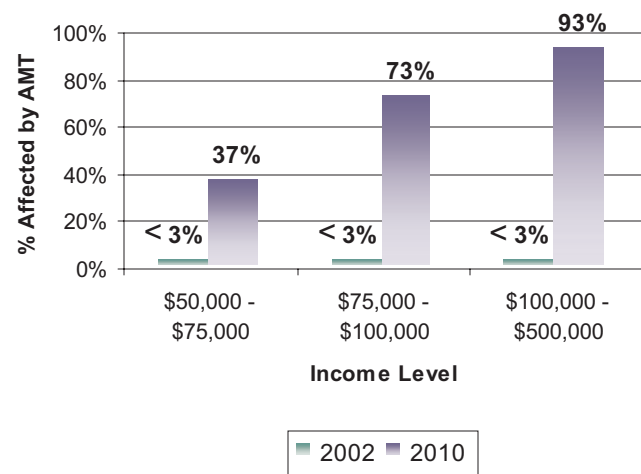
AMT applies to AMT taxable income in excess of an exemption amount at the rate of 26% on the first \$175,000 (\$87,500 for married individuals filing separately) and 28% on the balance. This tax amount is imposed to the extent that it exceeds the taxpayer’s regular tax liability. In essence, the amount calculated under the AMT becomes the individual’s tax liability.

<sup>1</sup>Michael J. Graetz, *The U.S. Income Tax: What It Is, How It Got That Way, and Where We Go From Here* 113 (1999).

The AMT provisions apply to trusts and estates, as well as to individuals. Activity in a trust or estate may have AMT consequences that pass through to beneficiaries and affect their tax returns.

Increasing numbers of taxpayers are facing AMT liability due to a combination of inflation and the recent income tax cuts, which have reduced the regular tax liability of many. The projected extension of the AMT's reach is dramatic. In 1999, it affected about 1 million taxpayers. Projections suggest that by 2010 it may affect 33 million taxpayers. As shown on the following graph, the AMT will affect households in almost all income levels.<sup>2</sup>

### % of Households Affected by AMT



Policymakers in Washington are looking at possible solutions for the AMT problem. In commenting on the AMT, Senate Finance Committee Chairman Charles Grassley recently stated that “[t]he alternative minimum tax isn’t so alternative anymore; it’s become pretty common.”<sup>3</sup> A bipartisan coalition of Senate Finance Committee members has introduced legislation to repeal the AMT. Other solutions short of an outright repeal might include indexing the AMT for inflation, significantly increasing the AMT exemption, or redesigning the AMT so that it would allow certain deductions and exemptions benefiting many taxpayers.

The obvious challenge that Congress will face in trying to enact a solution is loss of revenue. By one estimate, an outright repeal of the AMT would reduce federal tax revenues through 2014 by at least \$660 billion.<sup>4</sup> At this juncture, it is unclear what course of action, if any, Congress may take or when any changes may become effective. What is clear, however, is that until any change is made individuals face an increasing likelihood of being hit by the AMT and should understand its ramifications.

### Financial Impact and Planning Considerations

The basic financial impact of the AMT is that an individual who becomes subject to it suffers a tax increase. In addition to paying the amount determined under the regular income tax law, the person pays an amount that represents the excess of the AMT over the regular tax.

Counterintuitively, for many high-income taxpayers this tax increase is coupled with a reduction in their marginal tax rate. The highest income tax rate under the regular income tax is 35%, while the highest AMT rate is 28%. Given the convoluted array of phase-outs in today’s Internal Revenue Code that reduce exemptions and deductions as income levels increase, it can be a challenge to determine one’s true marginal tax rate. In many cases it will exceed the statutory tax rate. However, the marginal income tax rates for high-income individuals will be 35% for regular tax purposes and 28% for AMT purposes when their exemptions and deductions are completely phased out. For these people the AMT reduces their marginal tax rate by 7 percentage points.

These two impacts of the AMT, the tax increase and the marginal rate reduction, provide the context for AMT tax planning. In discussing this planning it is helpful to focus on two taxpayer profiles. First, there are individuals who normally are not subject to the AMT, but may be exposed to it in a given year as a result of a specific transaction. Second, there are more and more individuals who are subject to the AMT consistently each year.

### Individuals normally not subject to the AMT

Transactions such as sales producing unusually large capital gains or exercises of incentive stock options (“ISOs”) may push an individual not usually subject to it into AMT status. If the potential AMT consequences are recognized before the transaction happens, the individual may be able to avoid the AMT by reducing the transaction’s size. For example, someone who is trimming a concentrated stock position might sell just a number of shares each year that would avoid triggering the AMT. A corporate executive might take a similar approach in deciding how many ISOs to exercise.

In many cases, the individual will not want to scale back the transaction because its economic benefits outweigh the AMT tax cost. As advisors frequently stress, one should not let the tax tail wag the dog. In these instances, the individual at least may be able to take steps to mitigate the AMT tax cost before the end of the tax year.

One such step would be to delay until the following January paying the fourth installment of estimated state income taxes. Since state taxes are not deductible for AMT purposes, any state taxes paid during the year of the transaction will produce no federal income tax benefit. If the estimated payment is delayed until January of the following year, it will provide a tax benefit in that year if the individual is no longer subject to the AMT.

This strategy of delaying payments until the following year might also be appropriate for items, such as charitable contributions, that are deductible for AMT as well as for regular tax purposes. Due to the marginal rate difference between the regular tax and the AMT, the deduction may provide a greater tax benefit if it is taken in the subsequent, regular tax year. For example, the tax benefit of a \$25,000 charitable deduction is \$7,000 when the individual’s marginal tax rate equals the 28% AMT rate. The tax benefit increases to \$8,750 when the marginal tax rate is 35%.

Similarly, income items might be accelerated into the current year to take advantage of the lower AMT marginal tax rate.

Business owners who can control the timing of billing and collections and corporate executives who can accelerate the receipt of year-end bonuses might take advantage of this planning opportunity.

The AMT tax increase imposed on an individual in the current year might be returned to some extent in a future year by a credit called the “credit for prior year minimum tax liability.” This credit would be available in future years in which the individual is again paying the regular income tax. Unfortunately, the scope of this credit is limited, and it will benefit fewer people over time as greater numbers become subject to the AMT consistently each year.

### Individuals consistently subject to the AMT

Individuals who are subject to the AMT consistently each year have fewer AMT-specific planning opportunities. Still, there are several observations worth making.

An effective overall strategy for some people is to avoid concentrating income items in a given year and, instead, to smooth them out over time. This approach may reduce the impact of a phase-out of the AMT exemption and maximize the benefit of the 26% AMT tax bracket. As an example of this strategy, individuals might take their first minimum required distribution from an IRA in the year in which they turn 70½, rather than delaying it to April 1 of the next year and bunching two required distributions in that year.

Investors will be pleased to know that the favorable 15% tax rate that applies to most dividends and long-term capital gains continues to be available under the AMT. Also, in managing investment portfolios for investors subject to the AMT, sheltering capital gains by recognizing offsetting capital losses continues to be a sound strategy for enhancing after-tax returns.

An individual’s consistent exposure to the AMT could affect the investment decision of whether to hold municipal or taxable bonds. A person who has a lower marginal tax rate due to the AMT will receive less of a benefit from the tax

<sup>2</sup> Graph developed from data in Urban - Brookings Tax Policy Center, *Key Points on the Alternative Minimum Tax* (2004).

<sup>3</sup> *Senators Work to Repeal AMT*, Investment News, May 30, 2005.

<sup>4</sup> Urban - Brookings Tax Policy Center, *supra*.