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Minimizing the
AMT Tax

**Stealth Tax: Planners Try to
Protect Clients from the AMT**



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Stealth Tax: Planners Try to Protect Clients from the AMT

by Nancy Opiela

Stealth tax...an unpleasant surprise...a runaway train...unfair...however you describe the alternative minimum tax (AMT), there's no doubt it demonstrates a case of unintended consequences. It was enacted in 1969 to target fewer than 200 of America's wealthiest taxpayers who were managing to avoid paying their fair share to Uncle Sam through the use of excessive deductions and loopholes. Yet because the AMT has not been indexed for inflation and because ordinary income tax rates have fallen, according to Nina Olson, of the National Taxpayer Advocate, by 2010 the AMT will bite 30 million taxpayers!

"The AMT was never intended to do what it is doing," says Barbara Steinmetz, CFP®, of Steinmetz Financial Planning in Burlingame, California. "While it's intended for high-income people, it's affecting some of my clients who are barely making \$100,000 a year. In this part of the country, mortgage interest of \$33,000 to \$35,000 and property taxes between \$15,000 and \$18,000 are common, and that alone is often enough to trigger the AMT and cost clients more in taxes. It's unfair."

Across the country, in Glastonbury, Connecticut, the frustration of Mark Briggs, CPA, CFP®, PFS, is similar.



Ken Shapiro

“In some cases, we’ve been able to negotiate with the employer to reduce the base salary and cover those expenses as the company’s business expenses.”

Nearly half of his clients were hit last year with the AMT. “In my town, the combination of high income and high property tax, coupled with a 5 percent state income tax, means most couples earning close to \$200,000 will be hit with the AMT,” says the principal of Briggs Wealth Management LLC.

And those hits amount to more than small change. Marty Van Acker, CFP®, CPA, of Nykiel Carlin Financial Services in Schaumburg, Illinois, says a CPA firm affiliated with his firm completed approximately 2,600 individual returns last year. Of those returns, 8.3 percent had AMT liabilities with an average of \$4,579 of AMT per return above what they would have paid under their regular return. “Clients with itemized deductions for taxes and miscellaneous deductions are affected most, especially if their AMT exemption is phased out because their income exceeds the threshold amounts,” says Van Acker.

According to a recent Financial Planning Association (FPA) poll, planners rank reform or repeal of the AMT a high third as a public issue. FPA supports proposed legislation by Congress that would repeal the AMT. But considering the revenue the AMT generates—estimated by the Tax Policy Center at more than \$1 trillion over the next ten years—and with pressure on the U.S. Treasury due to the war in Iraq, disaster relief, and rebuilding costs from Hurricanes Katrina and Rita, it's unlikely Congress will turn its attention to the AMT any time soon. In the short term, planners expect the AMT to remain a part of the tax code, and will concentrate on ways to get their clients out of the way.

But that won't be easy, say planners. Kenneth Shapiro, CPA/PFS, CFP®, of Shapiro Financial Security Group in Hazlet, New Jersey, estimates that 25 to 30 percent of his tax clients were subject to the AMT in 2004. “Their

AGI income ranged from a low \$100,000 to \$250,000," he notes. "The impact for the 2004 tax year and probably 2005 has been minimized by the temporary extension of higher exemption amounts used within the tax calculations, but I am I expecting much greater impact in 2006 unless Congress passes repeal or reform."

Here, planners share strategies for dealing with the AMT, a simple tax that can be difficult to avoid.

Take a Multi-Year Perspective

Avoiding or minimizing the impact of AMT requires both a multi-year perspective and adopting strategies such as accelerating income and deferring deductions that are counter-intuitive to most clients.

For example, Briggs had a client sell a house with a gain of over \$1 million who he knew would be facing the AMT. "She owed \$50,000 to the state, but didn't want to make that payment in the same year she was getting hit with the AMT because those taxes wouldn't be deductible on the federal form. So we paid just enough to avoid the penalty and will make the rest of the payment the following year when we can write the amount off," he explains.

Tom Davison, Ph.D., CFP®, of Summit Financial Strategies in Columbus, Ohio, adds that in the rare cases when clients with unusually high income are not affected by the AMT, he uses the opportunity to pull additional deductions into that tax year. "We saved one client on the order of \$30,000 in later-year taxes by having them advance their real estate tax payments, fully pay their state estimated taxes, and exercise a small block of incentive stock options, all in a year when their

income spiked," he reports.

Often this type of planning can result in a one year on, one year off pattern with the AMT, says Davison. "Whenever there is a gap between the AMT and the regular tax, we ask if there's anything we can do about it. In Ohio, we pay real estate taxes twice a year, in January and July. If I'm not quite at the AMT now, I'm going to pay the final bill before December 31 to bring my regular tax down. If I'm in the AMT category, I'll wait until January to make my payment in a year where it could be deductible. You also can intentionally under-withhold to the state, maybe even to the point where you pay the state a penalty of 6 to 7 percent. If that gets your state tax payments into a year where they are deductible, it's worth the penalty."

Steinmetz cautions, however, that there are never any guarantees with this approach. "We don't have a crystal ball that tells what's going to happen in the market," she says. "For example, currently I am selling my clients out of REITs. They have substantial gains they had not planned on taking this year that could trigger the AMT."

Watch Out for Incentive Stock Options

While the majority of clients know that they don't have to report income when they exercise an incentive stock option (ISO) and won't pay capital gains until they sell shares, most don't realize that AMT rules require them to add ISO "income"—the spread or the amount the stock's fair market value exceeds what they paid for it—back into their compensation.

In some cases, Steinmetz suggests clients take a disqualifying disposition.

"If they sell the stock right after they exercise the options, they will be taxed at their ordinary income tax rate rather than at the lower capital gains rate they could qualify for if they held the stock," she explains. "They may insist they want the capital gains rate, but is it worth trying to avoid the AMT rate of 26 or 28 percent on the off chance that stock increases in value and you get a 15 percent capital gains? We get a little too focused on that 15 percent. Especially in a declining market, a disqualifying disposition is better than watching your shares plummet so far below your exercise price that you are taxed on gains you never realize."

Michael Kitces, MSFS, CFP®, CLU, ChFC, of Pinnacle Advisory Group in Columbia, Maryland, adds that "there were clients who exercised options in 2000 who, in pursuit of getting a favorable tax rate—then 20 percent on capital gains—held onto stocks that were not viable investments. Sure, they may have saved 5 percent on their marginal tax rate, but the stock lost 70 percent of its value."

He notes that to minimize the impact of the AMT on ISOs, it may be wiser to exercise options each year rather than bunching them together because spreading ISO gains out over a number of years could reduce or even eliminate the AMT.

Kitces cautions that exercising ISOs has all sorts of secondary tax impacts. "To the extent exercising options results in an AMT bill, you get a partial, minimum AMT tax credit to carry forward to future years that can reduce your regular tax liability, but not below your AMT liability," he explains. "The idea here is to ensure you don't pay twice on the same gain. But because of the AMT

creep where AMT bills are higher year after year, clients often end up carrying large AMT credits forward that they can't use."

Kitces further notes that a stock you acquire when you exercise an ISO has a basis equal to the amount you paid, but a different basis for purposes of the AMT. "The stock's AMT basis is equal to the amount you paid plus the amount of the AMT adjustment. That means you'll report a smaller amount of gain for AMT purposes when you sell the stock," Kitces explains. "Accordingly, it's important to ask new clients where the stock they hold originally came from. Did they exercise an ISO? If you don't ask, you may not be using the higher cost basis and in some situations clients could end up paying twice when they sell the stock."

William Supper, CFP®, of Massey, Quick & Co. in Morristown, New Jersey, "When dealing with ISOs, you need to roll up your sleeves and understand what the various tax ramifications are. Many clients are afraid to exercise the options due to the AMT, but you don't want to let the tax tail wag the dog. If it makes good economic sense to exercise the options and pay the AMT, so be it."

Control Your Income Stream

With a number of clients who have large unreimbursed business expenses that are disallowed for AMT purposes, Ken Shapiro often negotiates with their employers to restructure compensation packages.

"Many clients have a base salary or certain level of commission and they have to pay all their home office and travel expenses," he explains. "In some cases, we've been able to negotiate with

the employer to reduce the base salary and cover those expenses as the company's business expenses. That means a lower AGI for the client, and the benefit to the company is that they don't have to pay Social Security taxes on their own business expenses."

Van Acker adds that small-business owners who are "in control of their own destiny can control when to take income from their businesses." He explains, "It's a matter of looking into the details and helping them make good tax choices. Maybe they should accelerate their pay, or maybe they need to accelerate deductions. Often, making a bigger contribution to a qualified retirement savings plan can be helpful. Most of the businesses I work with are S corporations, so any deductions they take at the business level affect the 1040."

Supper notes, "For clients over age 59 1/2 in the upper federal ordinary income tax brackets who find themselves hit with the AMT, it may be a good move to take a greater-than-usual IRA distribution or convert a traditional IRA to a Roth IRA, and pay taxes at the lower marginal AMT rate of 28 percent."

Kitces explains, "Let's say you calculate your taxes based on your current income and your AMT is \$100,000 and your regular tax rate is 35 percent and an AMT of 28 percent. Whatever it was that got you there, your AMT bill is \$100,000, but it's figured at just 28 percent."

He continues, "In this case, you might take more out of an IRA than you would ordinarily, especially if you are someone who has some kind of income timing event where this

year you will be subject to AMT and almost certainly not the next year. Of course, we don't advise withdrawing retirement money you don't need because you lose the tax-deferred growth, but if it's November or December and you know you'll need \$10,000 from your IRA in the next three months, it may be better to take it now rather than wait."

Review Clients' Fixed-Income Portfolio

Another little-known fact is that in AMT-land, private activity municipal bonds are subject to AMT adjustments. And while they are in the minority of municipal bonds, private activity bonds are worth planning around. Says Kitces: "Typically, if the holding period, credit quality, and tax status are equal, apart from the AMT issue, the spread between private activity bonds and non-AMT-affected municipal bonds is usually 10 to 25 basis points. The end result is that if you are subject to AMT, where the best tax bracket is 26 percent, you should never buy AMT-affected municipal bonds. It's virtually always a losing proposition.

When calculating yields for private activity bonds, Kitces stresses it's important that planners use clients' AMT marginal rate, not their regular tax rate. Planners should also evaluate whether buying corporate bonds or Treasuries rather than municipal bonds makes sense from a tax perspective.

Review Debt Management Issues

Many clients take home equity loans without realizing that acquisition and equity indebtedness are treated differ-

ently under AMT. Debt of up to \$1 million to acquire, build, or improve a home, and home equity indebtedness interest up to \$100,000, are both fully deductible for regular tax purposes. But home equity indebtedness is not deductible under AMT if the equity is used for anything other than improving the home (say for college). "That's not clear on all the advertisements clients are bombarded with," says Shapiro.

So if an AMT-prone client has cash they anticipate using for something other than what qualifies under AMT, they may want to avoid sinking it into the home with the idea of extracting that money later. Once clients have a lot of equity indebtedness, there's not a lot planners can do, admits Shapiro. "We do a lot of projections, looking a few years ahead and planning accordingly," he explains. "Sometimes a client will be buying a home and wants to put a large amount of cash down so the mortgage payments are manageable. But if there's potential that they will want to tap into their home equity five years down the road for college, we suggest they may be better off putting a smaller amount down on the house and keeping more cash on the side to invest for college."

Adds Tom Davison, "Some AMT planning means letting clients know what to expect. For example, boat loans for large boats with kitchens and bathrooms are deductible under regular tax but not under AMT."

Make Use of Your Children's Tax Brackets

Davison also notes that sometimes the loss of dependent exemptions in the AMT calculation makes using a client's children's tax brackets more useful.

"Sometimes I suggest gifting stock to the children and having them sell appreciated securities to pay their own expenses," he notes. "Of course, you have to be careful not to use the proceeds for the basics, but expenses like a soccer-team fee or tuition for summer camp could be covered by the children."

Don't Count on 15 Percent Capital Gains

Clients love to focus on the lower capital gains tax rate, but that may be illusive if they are affected by the AMT, says Davison. "Capital gains are taxed at normal 15 percent long-term rates, except in the AMT exemption phaseout range. There, clients may be taxed at up to 22 percent on a marginal basis. This increases the value of doing tax-loss harvesting. The capital gains whammy is multiplied in states like Ohio, which has high income tax rates (non-deductible for AMT), and which taxes capital gains as income. Thus, capital gains can end up being taxed at about 30 percent in Ohio, and even slightly higher in other states."

All Is Not Lost

Planners often hear clients complain that the AMT strips them of all deductions. But charitable deductions are not lost with AMT, and by increasing charitable deductions, the amount of income taxable under AMT rules is reduced. It's important that planners clarify this for clients. In fact, charitable deductions might be worth more to clients in years when they are subject to AMT than in years when they are not.

Davison says it's important to focus on what you can control and to

stay positive: "It sometimes helps clients to realize that the AMT exposure they have is a result of their other tax being reduced by the recent federal tax cuts," he explains.

In fact, in some instances, clients may be paying less under the AMT than they would have, had the regular tax rates not been reduced. The best planners can do, suggests Davison, is to offer proactive planning that keeps multiple years' tax situations in mind. "The biggest help to clients dealing with the AMT is clear information about what it is and isn't subject to the AMT and knowing that they have done as much as they can to minimize the tax's impact. The AMT is a big, ugly, undifferentiated black cloud for them before you lay out how it works and how to work with it."

"While I prefer outright repeal of the AMT, the impact on the federal deficit makes this highly improbable until overall reform of the tax system is created. So in the meantime, reform is absolutely necessary. I would allow standard deduction and personal exemptions, real estate taxes on primary residence, medical expenses at the same 7.5 percent limitation as the regular tax, state and local income taxes, at least to a specified limit or percentage, and equity indebtedness interest expense the same as regular tax rules. I would also raise base exemptions amounts, index the AMT for inflation, and raise regular income tax rates for higher-income taxpayers."

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