TAX REPORT

Beware the Stealth Tax

How to minimize the damage of the alternative minimum tax.

By LAURA SAUNDERS

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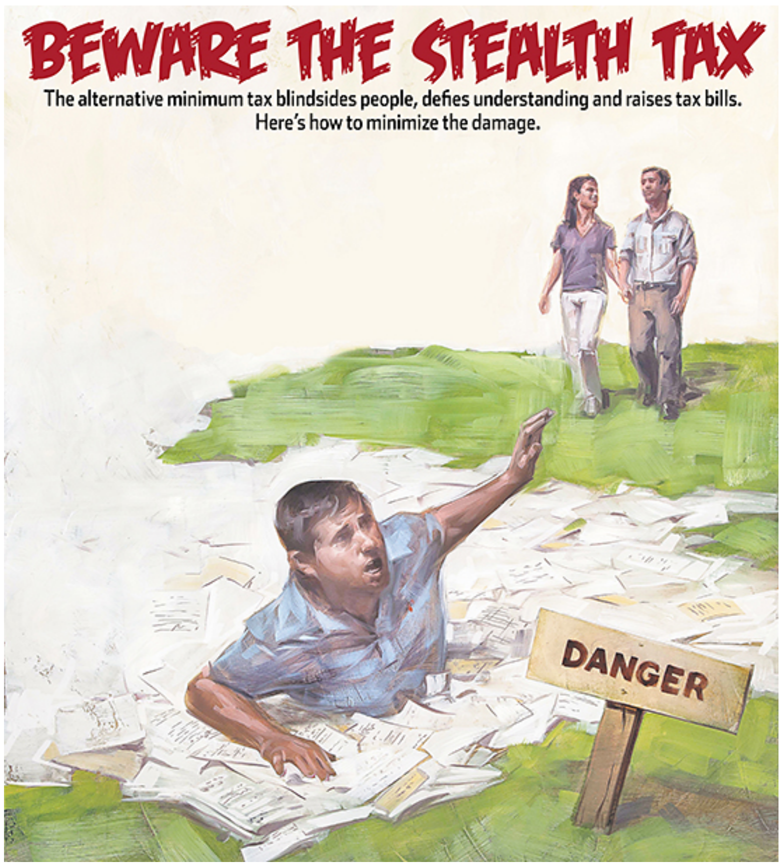


David Palumbo

Lee Linton never dreamed he would owe the alternative minimum tax, a levy first imposed nearly 50 years ago to keep the wealthy from overusing tax breaks.

"I thought the AMT was for people with stock options or fancy tax moves," says the 55-year-old utility engineer, who lives in Crystal River, Fla. "But I'm single and take the standard deduction."

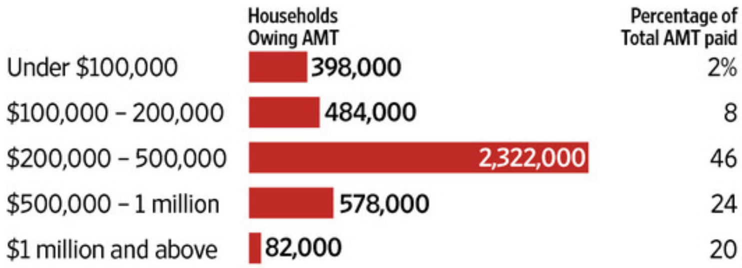
Yet when Mr. Linton recently figured his 2013 taxes, he owed $3,000 of AMT on top of his regular tax bill—probably because he took $90,000 of capital gains last year in rearranging his portfolio for retirement. He says his marginal tax rate on the sale topped 27%, nearly double the 15% rate he expected to pay on his long-term capital gains.

"If I had seen it coming, I would have spread the sale over two years," Mr. Linton says. Now he is warning friends that "the AMT isn't just a tax for the 1%."

Indeed it isn't. According to estimates by the Tax Policy Center, a nonpartisan research group in Washington, the alternative minimum tax will raise about $26 billion from four million taxpayers in 2013, nearly two-thirds of them with incomes between $200,000 and $500,000 (see chart on this page).

Who Will Owe AMT on April 15

The alternative minimum tax is projected to raise $26 billion from about 4 million taxpayers for 2013, most of them earning between $200,000 and $500,000.*



*Income includes pretax wages; investment income; the value of deferrals, such as for retirement savings; and the value of employee benefits, such as for health care.
Source: Roberton Williams, Tax Policy Center

The average AMT paid by those subject to it was $7,212 in 2011, according to the most recent data from the Internal Revenue Service.

The levy these taxpayers face is one that National Taxpayer Advocate Nina Olson calls "a Rube Goldberg contraption of unnecessary complexity." In essence, it is a flat tax that rescinds valuable benefits, such as deductions and exemptions, and eliminates the benefit of lower brackets in the regular tax.

Taxpayers have to figure their tax under both the AMT and regular systems and, if the AMT exceeds the regular tax, pay the excess amount.

Years ago, say experts, the AMT was typically owed by wealthy investors or executives who had benefited from breaks for incentive stock options, accelerated depreciation on assets, intangible drilling costs and the like.

But not now. Lawmakers enacted adjustments that prevented 28 million new taxpayers from owing AMT for 2013 in last year's fiscal-cliff legislation. But they didn't undo the effects of many earlier years of inflation that still pulls in many others, says Roberton Williams, a Tax Policy Center expert.

Maxing Out

The 10 jurisdictions with the highest percentage of AMT taxpayers.

STATE	PERCENTAGE OF TAXPAYERS OWING AMT	AVERAGE AMT PAID
New Jersey	9.2%	$7,250
Connecticut	8.2	8,383
New York	8.1	9,901
District of Columbia	7.9	7,673
California	7.1	9,027
Maryland	6.9	6,291
Massachusetts	6.7	7,349
Virginia	5.4	5,656
Illinois	5.1	6,187
Minnesota	4.4	7,055
U.S.	4.5	7,212

Source: Internal Revenue Service data for 2011 tax year
The Wall Street Journal

As a result, the AMT now applies to eight times as many taxpayers as it did 20 years ago, and common AMT "triggers" often are less esoteric than in the past. "They can be as simple as having three or more children, taking a large capital gain, or—especially—deducting state and local taxes," says Dave Kautter, managing director at American University's Kogod Tax Center, who studies the AMT.

Some taxpayers, like Mr. Linton, are blindsided by the AMT because of this expansion. Others don't see it coming because the levy's impact is unpredictable, the result of odd interactions between two utterly different systems.

Larry Gottlieb, an 83-year-old retired pathologist in Madison, Wis., says he will owe AMT for the first time this year. It will add $900 to his regular tax bill, even though virtually all his income is from an individual retirement account and his modest deductions have changed little since last year.

"My frustration is, I can't figure out what triggered it," he says.

For taxpayers struggling with the AMT, there is some good news: Congress's top tax-policy makers—House Ways & Means Committee Chairman Dave Camp (R., Mich.) and Senate Finance Committee Chairman Ron Wyden (D., Ore.)—both advocate ending the levy, and AMT repeal is included in Rep. Camp's tax-overhaul proposal, which he released Wednesday.

But that could be long in coming, especially as lawmakers will need to make up lost revenue from elsewhere. Until then, here is what taxpayers need to know about the AMT to help minimize or even avoid it.

What's the rate?

The AMT's rate isn't always what it is advertised to be, and neither is the exemption. Its top nominal rate is 28%, and the 2013 exemption is $80,800 of AMT income for married couples filing jointly ($51,900 for single filers).

But taxpayers should take those numbers with a grain of salt. Because the AMT's exemption phases out starting at $156,500 for couples and $117,300 for singles, a taxpayer's marginal rate can be 35% during the phaseout.

"This can be a trap for people who assume their AMT rate will be 28%," Kogod's Mr. Kautter says. Once the phaseout is complete, the taxpayer may return to a 28% AMT rate or re-enter the regular tax system.

Taxpayers also should be aware that "AMT income," and therefore the AMT exemption, often bears little relation to figures appearing elsewhere on the tax return, such as adjusted gross income or taxable income, because the AMT is a separate system with a different definition of income.

Some write-offs are more equal than others.

The AMT allows some deductions, clips others and disallows others entirely.

Lindsay Holmes

Deductions allowed by the AMT include charitable contributions and mortgage interest—but not home-equity-loan interest, with some exceptions.

Curtailed deductions in 2013 include some medical and dental expenses normally allowed for people over 65, plus a variety of business items, such as depreciation and net operating losses, that are postponed until later years.

Disallowed deductions include those for state and local taxes, plus miscellaneous items such as unreimbursed travel expenses and investment fees.

Experts say that high state and local taxes are one of the most important AMT triggers for many people, either alone or in combination with others. High-tax states tend to have the highest percentages of AMT taxpayers (see chart on this page). A small consolation for this large deduction loss is that often all or part of a state tax refund isn't taxable under the AMT, either.

For a full list of AMT "preferences," as the disallowed benefits are called, see IRS Form 6251 and its instructions.

There's nothing standard about the standard deduction.

Taxpayers who don't itemize their deductions separately on Schedule A typically claim the standard deduction instead. For 2013, it is $12,200 for married couples and $6,100 for single filers.

But the standard deduction is disallowed under the AMT. Thus Mr. Kautter advises AMT payers who usually take it to see whether they could save tax by itemizing deductions such as mortgage interest and charitable contributions on Schedule A—even if the total comes to less than the standard deduction would.

"It could be the difference between getting a partial deduction and none at all," he says.

The AMT is family-unfriendly.

For 2013, each personal and dependent exemption is worth $3,900 under the regular tax. (A dependent is typically your child or someone you support by paying more than half their expenses.) Under the AMT, these deductions aren't allowed.

While family size obviously shouldn't be determined by the AMT, experts say that taxpayers with large families should remember they are more likely to owe the tax than others, especially if they have other triggers.

Beware of investment income.

Long-term capital gains aren't a formal trigger for the AMT, and long-term gains and qualified dividends remain taxed at lower rates even for AMT taxpayers. And no, the AMT doesn't limit the use of capital losses.

But taxpayers shouldn't ignore the potential for investment income to act as an informal AMT trigger.

"When someone has a high ratio of long-term gains or dividends to total income, they are much more likely to owe AMT," says Andy Mattson, a certified public accountant at Moss Adams in Campbell, Calif.

That's because gains and dividends count as income for AMT purposes, which may in turn accelerate the AMT exemption phaseout. In addition, such income often generates deductible state taxes, which also can help raise the AMT, he says.

While most municipal-bond income isn't subject to the AMT, interest from so-called private-activity munis is, and regular munis can generate deductible investment fees that help trigger the tax.

The 2013 tax increases may actually lower AMT bills for some people.

In addition to limiting the AMT's reach, last year's fiscal-cliff legislation raised tax rates for high earners and added two backdoor tax increases for couples earning $300,000 or more ($250,000 for singles). One of them, called the Pease limit after the congressman who sponsored it, trims itemized deductions, while the other, known as PEP, phases out the personal exemptions.

As a result, says Chris Hesse, a principal at CliftonLarsonAllen in Minneapolis, some taxpayers will owe more regular tax and less AMT for 2013.

In fact, Mr. Hesse says, residents of high-tax states who have long owed AMT may not feel the effects of the PEP and Pease increases as much as residents of low-tax states such as Texas or Florida.

"People who've always lost some deductions and exemptions due to the AMT, are less likely to be affected by the 2013 increases," he says.

To minimize your AMT bill, lower income, watch out for bumps and don't guess.

While avoiding the AMT will be impossible for some taxpayers, experts recommend three overall strategies.

The first is to reduce reported income wherever possible, such as by contributing to tax-sheltered retirement plans and using pretax dollars to pay medical or child-care expenses. Small-business owners should try to claim expenses on a Schedule C business form rather than on their personal returns.

IRA owners 70½ and older should consider making charitable contributions of IRA assets instead of cash, assuming Congress reinstates this expired benefit for 2014.

The second strategy is to check out the tax effects of unusual increases or decreases in income, such as a large capital gain or a loss of income, and plan for its effects over several years, not just one.

Careful planning could help avert the AMT or perhaps take advantage of a temporary hiatus in the tax.

Finally, never guesstimate the AMT. The tax is so complex that even the experts say they can't predict it. Says Mr. Kautter: "Run the numbers, run the numbers and run the numbers."

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