ADVISER INVESTMENTS

ADVISER FUND UPDATE

Market Summary and Commentary for Individual Investors from Adviser Investments

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The Alternate Tax Reality

By now, you should have received your tax documents from your employer and investment custodians in advance of one of the most dreaded days on the U.S. calendar--tax day. While we get three extra days this year to prepare our taxes (April 18, 2011 is the deadline for filing your 2010 returns), the recurring nightmare of the AMT, aka the Alternative Minimum Tax, just won't go away.

Congress created the AMT in 1969 after discovering that 155 taxpayers making over $200,000 (a large sum in those days) had avoided paying any federal income tax. Unfortunately, the AMT was not indexed to inflation and, over the years, it has begun to affect more and more people. Thanks to a last minute patch approved by congress in late December as part of the 2010 Tax Relief Act, about 4.4 million taxpayers will have to pay up under AMT rules for tax year 2010 (had there been no patch, that number would have jumped up to an estimated 28.6 million), and they could owe thousands of dollars more on their returns as a result.

Essentially, the AMT functions in a parallel universe to the normal income tax, with different rates and methods of calculating income and deductions. If you fall into a certain income range, you have to calculate both your normal income taxes and the AMT and then pay whichever is higher. Many more than the aforementioned 4.4 million people who will be subject to paying the AMT will have to take hours filling out the necessary worksheet and form to figure out whether they owe it or just the normal income tax.

Possibly the most frustrating aspect is that many people who go to the trouble of filling out the AMT form will find that, in the end, they don't owe the tax. But since the number of people subject to the AMT has begun to rise, the IRS has been keeping a sharper eye out for AMT-related mistakes, so it's in your best interests to fill out the AMT worksheet, or to hire a professional to help you out if you're unsure about your return (any good do-it-yourself tax software should include an AMT questionnaire and calculate it for you as you fill out your return, as well).

You can expect to be subject to the AMT (or at least to filling out the form) for tax year 2010 if your taxable income exceeds the exemption, which is currently $72,450 for married couples and $47,450 for singles and heads of households. As the law now stands, these amounts will drop considerably for tax year 2012 (there is a provision already in place for 2011), which would cause the number of taxpayers hit by the AMT to jump to that estimated 28.6 million households if no further patches are applied.

The people who should be most concerned about the AMT are those with children; especially two or more. According to the Urban-Brookings Tax Policy Center of Washington, D.C., for tax year 2012, when the most recent AMT patch expires, 43% of married couples with two children and 48% of married couples with three or more children will have to pay the AMT. And for those with higher levels of income, 94% of households with income between $200,000 and $500,000 and 80% of households with $100,000 to $200,000 in income will have to pay for tax year 2012 (all of the percentages listed above are based on the assumption that the Bush tax cuts are extended).

In the past, part of the reason that congress and the president have been unwilling or unable to eliminate the AMT is the amount of revenue it generates. If the Bush tax cuts, already extended two years, are extended beyond 2012, the AMT will generate an estimated $1.2 trillion in tax revenue over the next decade (this assumes annual patches to index the AMT to inflation; without patches the number would be substantially higher). We'll have to wait until 2012 to see if any kind of consensus can be reached on how to change or eliminate the AMT. A bipartisan presidential commission recommended abolishing the AMT in a November 2010 plan, but President Obama's proposed 2012 budget includes no permanent solution, just another patch, this one to last three years.

For those of you who exercised incentive stock options (ISOs) and qualified for the AMT as a result, there is a little-known provision that could potentially net a refund. Regular taxes do not factor in the "bargain element" of exercising an ISO; AMT taxes do, meaning that you're taxed on the difference between the fair market value of the ISO shares and the exercise price on the date you exercise the option. This can add up to a substantially larger tax bill. This is where the "AMT credit" comes into play--taxpayers subject to the AMT who exercise ISOs are generally granted a credit that can be carried forward indefinitely and applied to future tax returns to cover amounts in excess of what you'd pay under the AMT (this typically comes into play when your normal income taxes are marginally higher than the AMT, giving you a small break). If you earn an AMT credit one year and are subject to the AMT the next year, the credit cannot be used. However, there is a very beneficial exception if you have AMT credits that are more than three years old--these old credits become refundable, which means they can be used to reduce taxes and give you the opportunity to collect any leftover amounts in cash. So if you have been hit with big AMT tax bills in the past and think you may have credits, we strongly urge you to look into this provision--it might just put some money back in your pocket.

Fidelity, along with several other mutual fund companies, has taken some steps towards helping investors stave off paying the AMT. The firm currently offers six AMT-sensitive municipal money market funds (AMT Tax-Free Money Market, Tax-Free Money Market, California AMT Tax-Free Money Market, Massachusetts AMT Tax-Free Money Market, New Jersey AMT Tax-Free Money Market and New York AMT Tax-Free Money Market), and two AMT-sensitive bond funds (California Short-Intermediate Tax-Free Bond and Tax-Free Bond) which seek to invest only in securities whose interest is exempt from the AMT (and normal income taxes as well). While these funds can provide AMT protection when used in a wide-reaching tax strategy, don't expect them to protect you from having to calculate the AMT just because you hold them.

Vanguard has not elected to provide any AMT-free funds as of yet, instead limiting most funds' holdings to a max of 20% of assets in bonds with interest subject to the AMT. The reason, according to Christopher Ryon of Vanguard's Fixed Income Group, is that eliminating AMT-taxable bonds would reduce diversification and lower the yields of certain funds.

This alternate tax reality is a problem for taxpayers that will keep growing each year, and regrettably, unless the government takes action, there is no simple solution. We would like to be able to give you some specific advice about how to beat the AMT, but in this case the power for change lies with congress and the president. Mutual fund families may be able to help out to a small extent by offering more AMT-free funds, but these are not the kinds of funds most investors will flock to, at least for a majority of their assets. Our best suggestion is to consult with a tax specialist if it seems as though you'll have to pay the AMT or if you've paid it in the past and think you might qualify for the credit. While it's no fun to owe extra cash as a result of the AMT, at least you'll have the peace of mind knowing that your returns were correctly calculated and that the IRS won't be sending you threatening letters and charging you interest over unpaid taxes.

About Adviser Investments

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