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 preparation for one of the most feared dates on the U.S. calendar: Tax day. The only welcome news? There are a couple of extra days this year to prepare due to Washington, DC's celebration of Emancipation Day on April 15, pushing the deadline to file your 2015 returns to Monday, April 18, 2016.

You can use the extra days to determine if the Alternative Minimum Tax (AMT)—or, as the Tax Policy Center calls it, "the epitome of pointless complexity"—is something you'll have to contend with. You may end up having to prepare for two separate tax liabilities while only having to ultimately pay one; maybe not 72 hours, but plenty of wasted time.

Essentially, the AMT functions parallel to the normal income tax system as an additional tax on people the IRS determines aren't paying enough in regular taxes, 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 pay an additional balance if the AMT is higher. Many people will be subject to paying the AMT, but many more will spend hours filling out the necessary worksheet and form to figure out whether they owe it or just the normal income tax.

Congress created the AMT in 1969 after discovering that 155 taxpayers making over $200,000 (a princely income in those days) had avoided paying any federal income tax. The resulting embarrassment led lawmakers to create a parallel tax system intended to make things fairer by preventing taxpayers with very high incomes from claiming deductions to pay little to no tax. The AMT expanded the income that is taxed by including items that are tax-free and prohibiting many deductions allowed under the regular tax system.

But the AMT wasn't linked to inflation, and as time went by, more and more middle-income citizens got tangled up in it. Since the passage of the American Taxpayer Relief Act of 2012, the AMT is now linked to inflation, like Social Security, so

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taxpayers who don't have to pay it this year won't have to pay it next year unless their income increases faster than inflation. Unfortunately, that hasn't stopped millions of taxpayers from experiencing uncertainty about whether the AMT applies to them, and the legislative solution did not restore the AMT back to its original purpose, since it still impacts middle-income taxpayers every year and will continue to do so until further changes are made (it typically gets some attention and mileage in election years). While we'd always suggest that you contact a tax professional for any tax-related decisions, there are some straightforward tips for most taxpayers to follow.

To find out if you are subject to the AMT, you must fill out IRS Form 6251 in addition to the regular 1040 tax return. A general recommendation is that anyone with gross income above $75,000 and has write-offs for personal exemptions, taxes and home-equity loan interest should run the numbers. The same holds if you exercised incentive stock options, or own rental properties, a business, partnership interests or S-corporation stock. Anyone making $100,000 in gross income should file Form 6251. The AMT currently impacts about a third of households bringing in $200,000–$500,000 annually and more than half of taxpayers earning $500,000–$1 million.

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 as 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 2015 if your taxable income exceeds the exemption, which is currently $83,400 for married couples and $53,600 for singles and heads of households. Given changes in the law, these amounts should rise with inflation for tax-year 2016.

If your income is below $200,000, many deductions you might be accustomed to are disallowed under the AMT. The people who should be most concerned about the AMT are those with children, especially two or more. Every child can be claimed as a personal exemption on the traditional 1040 filing; personal exemptions are not allowed under the AMT. Likewise, if you live in a state and city with high taxes, the AMT is more in play since you can't deduct state or local income taxes.

Other items that are not deductible when calculating the AMT: Medical expenses, business expenses, investment expenses and mortgage interest.

The ISO Wrinkle

For those 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 (or bring it to the attention of a trusted tax professional)—it might just put some money back in your pocket.

Funds to Fight the AMT

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 prevent you from having to calculate the AMT just because you hold them.

Vanguard does not provide any AMT-free funds as of yet, instead limiting a number of its tax-exempt, fixed-income funds’ holdings to a max of 20% of assets in bonds with interest subject to the AMT. The reason, according to Vanguard’s Fixed Income Group, is that eliminating AMT-taxable bonds would reduce diversification and lower the yields of certain funds.

Dealing With the AMT

Despite Congressional action that attempted to limit the expanding number of taxpayers ensnared by the AMT, it remains a confusing topic and one many taxpayers may be tempted to avoid. But be warned: Every taxpayer is required to figure out whether they owe money due to the AMT, and the failure to fill out the IRS' AMT Worksheet to determine liability and, if required, to file Form 6251 can be a red flag for IRS auditors. It's a major time commitment, but it is fortunately one that can be simplified by many of the tax preparation software options and websites available (or by having a tax professional prepare your return for you).

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 the AMT is an additional burden, at least you'll have the peace of mind knowing that your returns were correctly calculated and that the IRS won't be coming after you for interest and penalties on unpaid taxes.

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Adviser Investments and its subsidiaries operate as an independent, professional money management firm with particular expertise in Fidelity and Vanguard mutual funds. We advise more than 2,500 clients and have over $3 billion under management. Our investment professionals focus on helping individual investors, trusts, foundations and institutions meet their investment goals. Our minimum account size is $350,000. In 2015, Adviser Investments was named to *Barron's* list of the top 100 independent financial advisers nationwide for the third consecutive year and its list of the top advisory firms in Massachusetts for the second time. We have also been recognized on the *Financial Times* 300 Top Registered Investment Advisers list in 2014 and 2015.

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