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SPECIAL REPORT: ENCORE

Tax Trap

More retirees are getting hit with the dreaded alternative minimum tax. Here's how to soften the blow

By KAREN HUBE

Beware. There's a hidden land mine in the federal tax code that could blow a sizable hole in your retirement nest egg.

It's called the alternative minimum tax -- a provision that disallows almost all deductions and often costs people far more in taxes than they ever thought possible. Though the AMT originally was designed to prevent wealthy people from avoiding taxes, in recent years -- because AMT rates and exemptions haven't been adjusted for inflation -- the provision has started hitting millions of taxpayers for whom it was never intended.

More and more retirees are among them. Many are getting the nasty surprise in the first couple of years after leaving their jobs. Here's why: The more long-term capital gains and deductions you have relative to your ordinary income, the more likely you are to get smacked with the AMT. For retirees, whose ordinary income often declines while they still have sizable deductions for state taxes and property taxes, the AMT trap can be hard to avoid -- especially when these individuals start tapping their long-term gains to live on.

'The New Reality'

"They're getting punished, but they're doing nothing out of the ordinary," says Neil Lonergan, a tax partner at Grant Thornton, a tax-advisory firm based in Washington, D.C. "This has become the new reality of retirement for many people."

That's the case with James Burgess, 62 years old, of Madison, Wis. When he retired several years ago as a newspaper publisher, he began drawing down his investment gains to live on. Because he was living on less in retirement and long-term gains are taxed at 20%, Mr. Burgess says, "I figured my tax bite would go down." But he got hit with the AMT for the first time, and the proportion he paid in taxes "shot up by more than 25%," he says.

The AMT exists alongside the regular income-tax system. What you have to do is calculate your taxes under both the regular tax system on Form 1040

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RISK FACTORS...

The most common circumstances that can trigger the AMT

- Living in a high-tax state
- Taking large miscellaneous itemized deductions
- Paying high real-estate taxes
- Realizing large long-term capital gains
- Exercising incentive stock options

...AND PREVENTIVE STEPS

Strategies for avoiding or reducing the impact of the AMT

- Time state tax payments to coincide with a high-income year
- Accelerate or postpone deductions to match them to a year your income is higher than usual
- Draw down long-term gains over a number of years, rather than in a lump, and try to realize them in a year that your ordinary income is higher than usual
- Exercise incentive stock options when the market price is low, or in stages over a number of years; to eliminate the AMT altogether, sell your shares in the same year you exercise the options

and the AMT using Form 6251. If your AMT bill is higher, then you're in the AMT and you must pay that bill.

GETTING SNARED

Percentage of taxpayers subject to the AMT by adjusted gross income

Income	2001	2004	2005	2010
Less than \$30,000	0%	0%	0%	0%
\$30,000 to \$50,000	0	0	1	3
\$50,000 to \$75,000	1	2	7	18
\$75,000 to \$100,000	2	7	23	54
\$100,000 to \$200,000	7	19	46	85
\$200,000 to \$500,000	26	64	79	98
\$500,000 to \$1,000,000	18	21	21	68
\$1,000,000 and up	16	18	17	29
TOTAL	2	5	13	32

Source: Treasury Department

rare case that your only income is from long-term gains, your tax bill would be equal under the AMT and the regular tax system and you wouldn't get hit with the AMT. But if you deduct even a single dollar -- and most people have at least state-tax deductions -- that will bring your regular tax bill below the AMT bill, and you will find yourself facing the AMT.

"If you have income from a pension, dividends or an IRA -- which is taxed at ordinary income-tax rates -- that can help keep you out of the AMT," Mr. Lonergan says.

Stock-Option Trigger

There is another major AMT trigger, as well: exercising incentive stock options. Under the AMT, you have to count the spread between the exercise price (the price at which you use options to buy a stock) and the market price as taxable income, if you don't sell the shares in the same year in which you exercise the options. If, for example, your exercise price was \$10 a share and the market price was \$40, you would owe taxes on \$30 a share.

Under the regular tax system, when you exercise a stock option you don't owe tax until you sell your shares, and then you are taxed on any gain.

"Under the AMT, you're paying taxes on the spread, even though you don't realize any money until you sell the shares," Mr. Pincus says.

Oren Wolfe, 60, Annapolis, Md., a former electrical engineer at Corvis Corp., says he wasn't aware of the

If you just compare the AMT rates -- 26% and 28% -- to the highest marginal income-tax rate of 38.6%, falling into the AMT category might not seem like such a bad thing. In fact, some accountants say that clients see the rates and hear the word "minimum" and mistakenly may think it must be good to get taxed under the AMT.

But here's the reality: The only deductions you can take under the AMT are for charitable contributions and mortgage interest. All others -- including miscellaneous itemized deductions, property taxes and state taxes -- aren't allowed. As a result, under the AMT much more of your income is taxed. "Being in the AMT is never a good thing," says Andrew Pincus, senior tax manager at M.R. Weiser, a financial-services firm in Edison, N.J.

If you live in a high-tax state such as California or New York, or if you have high property taxes or other big deductible expenses, you will be more likely to fall under the AMT. That's because those taxes and expenses are deductible under the regular income-tax system but not the AMT. The bigger the deductions, the more likely your regular tax will be lower than the AMT.

If you draw down large long-term gains, that could tip the scale toward the AMT. Here's how: The long-term capital-gains rate under the AMT and the regular tax system is the same at 20%. So in the

AMT when he exercised his options just before his retirement. But soon after leaving his job he learned he owed \$100,000 in taxes. Now he is looking for a job to pay back a loan he took out to pay the tax. "I was hoping to play with boats, but I'm going to have to put off retiring for a while," he says.

Congress created the AMT several decades ago to help stanch the use of tax shelters, mainly among the rich. But in recent years, the provision has hit a rising number of middle-income taxpayers. Last year, 1.7 million people paid the AMT, and this year about 2.7 million will ante up, the Treasury Department says.

Tax Overhaul's Impact

The numbers are growing because the AMT rates and exemptions haven't been indexed to inflation over the years, while the regular tax system's standard deductions, personal exemptions and tax-bracket range have been adjusted. The reduction in tax rates under last year's tax overhaul makes the situation even worse because it is even more likely that your income tax bill will be lower than your AMT bill.

True, the tax act raised the AMT exemption to \$35,759 from \$33,750 for single taxpayers, and to \$49,000 from \$45,000 for taxpayers filing jointly. But even that modest relief is set to expire in 2004. After that, the AMT's reach is predicted to be even wider.

According to a report published by the Treasury Department last fall, before the tax act was passed, the number of individuals affected by the AMT was projected to grow to 18 million in 2010. With the passage of the law, 35.1 million people are expected to be hit by 2010.

Though many policy and tax analysts are calling for AMT repeal or at least revision, most say it's unlikely. With deficit fears rising, "it's largely a revenue issue," says Tom Pudner, manager of personal financial planning for KPMG national tax practice in Washington, D.C. The government will reap \$12 billion from the AMT this year and \$54 billion in 2010, according to the Treasury.

That said, the following steps could help you avoid or at least soften the AMT's blow:

Time your deductions and income carefully. The usual tax-planning advice is to accelerate deductions and defer income. However, if you're in the AMT -- or think you might be -- it can pay to do the opposite, Mr. Pincus says.

This strategy isn't always easy. If you have steady income from Social Security, pensions and other sources, manipulating funds could be difficult or impossible. But if you can, in a year you draw long-term gains or take bigger-than-usual deductions, try to bring in as much income as you can -- from, say, an IRA or 401(k). That way, you will either avoid the AMT, or at least take advantage of the AMT's lower rates.

But keep your long-term economic profile in mind. "You don't want to take IRA money if you don't need it and forgo future tax-deferred growth," Mr. Lonergan says.

When it comes to deductions, time your state and local tax payments carefully. If you pay all of your 2002 state and local taxes prior to year end, you must claim the deduction on your 2002 federal tax return. But any 2002 state and local taxes that you pay in 2003 prior to your tax-filing deadline can be deducted on your 2003 returns.

So if you think your income will be higher in 2003, consider waiting to pay your 2002 taxes after year end, Mr. Pincus says.

Set up a laddered portfolio of bonds. To avoid having to draw long-term capital gains frequently in retirement, "shift some of your portfolio to income-producing assets," Mr. Pincus says. If you buy bonds of differing maturities, they will throw off interest and mature in stages, creating income that is taxed at regular rates. Then, in a year that you think you will have to draw down gains from your stock portfolio to feed into your bonds, you can plan carefully in advance to try to avoid the AMT.

Consider taxable instead of municipal bonds. Conventional wisdom is to buy municipal bonds in retirement, so you can enjoy tax-free returns. But if you know you're going to be in the AMT category, you may want to stick with taxable bonds, Mr. Lonergan says.

"Taking advantage of the AMT's lower tax rate could give you a better after-tax yield on the taxable bond," Mr. Lonergan explains.

Steer clear of private-activity bonds. Even if you stick with municipal bonds, be choosy. There's a breed of municipal bonds called private-activity bonds whose interest is taxable under the AMT, even though they're tax-free under the regular tax system. These are bonds issued by private entities such as airports or shipping ports to develop projects that benefit the public. Be sure to ask your broker or check with your bond fund if you are exposed to these bonds.

Lean toward paying commissions instead of flat investment fees. If you're taxed under the AMT and you pay a flat fee for investment services, you will lose the opportunity to deduct the fee. Under the regular tax system, investment advisory fees are deductible; under the AMT they aren't.

"You'd be better off paying a commission, because it becomes part of the cost basis and would reduce your sale proceeds," Mr. Lonergan says. "It's essentially a deferred deduction."

Exercise your incentive stock options in phases. If you're facing retirement and still haven't exercised your incentive stock options, do so in stages. "Exercise small amounts spread over a number of years," Mr. Lonergan says.

Also, consider making your move when the spread between the exercise price and market price is narrow. That way, less will be counted as taxable income under the AMT.

And be aware of the escape hatch: If you exercise options and sell the shares in the same year, you don't have to count the spread as ordinary income under your AMT calculation. If you happen to post a gain from that sale, under the AMT it would be taxed as a capital gain, same as in the regular tax system.

Whatever strategies you adopt, you should consult a tax expert. The AMT is one of the most complex pieces of the tax code, and your best chance of dealing with it effectively is through careful long-term planning.

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