MIDDLE-CLASS TAXPAYERS CAUGHT IN TAX TRAP SET FOR THE WEALTHY

By Jay MacDonald • Bankrate.com

All set to enjoy your cut of the latest tax breaks?

Don't spend it too fast. If your taxable income and deductions meet certain criteria, you may lose that tax break and likely pay even more, thanks to a little known but increasingly worrisome "stealth tax" called the individual alternative minimum tax, or AMT.

As its name suggests, the AMT is a separate, but parallel, tax system that operates alongside the one we're used to wrestling with. The AMT imposes a flat tax of 26 percent to 28 percent. That doesn't sound so bad when you consider that the regular tax system has two higher rates, 33 percent and 35 percent.

The notoriously complex AMT, however, was designed to make sure that the wealthy paid their fair share of taxes. To that end, it has different definitions of income and allows fewer deductions. When all the calculations are complete, it produces a higher tax bill than does the regular tax system -- and the affected taxpayer must pay the larger amount.

And it's no longer just the affluent who are paying AMT. A growing number of not-so-wealthy taxpayers are discovering that they, too, are hit with this higher tax.

So what can you do to beat this extra tax burden? Unfortunately, not much. Because of its peculiarities, this parallel tax defies most traditional tax planning.

The best hope now for taxpayers is to convince lawmakers that changes need to be made to the AMT. Politicians normally might be receptive to the argument that the AMT burden is now falling on people for whom it was not meant. But the plea for AMT relief is complicated by the fact that regular tax-rate cuts have made the federal treasury more dependent on the alternative tax revenue.

While the tax debate continues, and to keep you from being blindsided by the tax, here's a look at the AMT's history and how you could fall into its clutches.

Why AMT?

Congress created the alternative tax in 1969 in the wake of testimony by Treasury Secretary Joseph Barr that 155 high-income households had paid zero tax in 1966.

Unfortunately, the lawmakers failed to index the AMT for inflation. As a result, the tax patch originally designed to target wealthy tax dodgers now is increasingly hitting unwitting middle-income households. If you have a large family, incentive stock options or live in states such as New York or California where state taxes are high, you may well be blindsided soon.

"A few years ago, we started seeing people with very large families getting hit with this tax. That was kind of the canary in the coal mine," says Beth Kern, associate professor of accounting at Indiana University.

"Now it's to the point that if you have four kids, it will eventually come to your door. When you look at the actual numbers and estimates that are coming out, it's phenomenal what is going to happen in the next couple years. It's on the way."

Scary scenarios
Got your attention? Now get ready for the scary figures.

William Gale, deputy director and senior fellow of economic studies at the nonpartisan Urban-Brookings Tax Policy Center, says that under current law, AMT coverage will skyrocket. In 1999, a million filers faced the AMT. By 2010, the tax will hit 33 million taxpayers, about one-third of all returns. The U.S. Treasury Department released figures on April 2 that project more than 46 million filers will pay AMT in 2014.

This would make the AMT almost as common as the mortgage interest deduction is today. The AMT will be the de facto tax system for households with income between $100,000 and $500,000, 93 percent of which will face the tax.

The Tax Policy Center's findings also show that the 2001 tax cut has increased the number of people subject to AMT. If the AMT had been indexed when the regular income tax was, and had the 2001 tax cut not been enacted, only about 300,000 households would face the AMT in 2010.

Among those hardest hit by the AMT are married couples and parents. Couples will be more than 20 times as likely as singles to face the AMT in 2010. Because the AMT prohibits deductions for dependents, 85 percent of married couples with two or more children will face the AMT. About 6 million taxpayers will face the AMT in 2010 simply because they have children.

Why don't federal lawmakers repeal the AMT? The short answer is money.

In comparing the AMT and regular tax rates, the Treasury found that if recent tax cuts are extended rather let expire as originally planned, the AMT will increase the amount of tax individuals pay in 2005 by $28 billion, rising to $177 billion in 2014. If the AMT system is unchanged, the Treasury predicts that in just a few years it will be more cost-effective to repeal the regular tax system and leave the AMT in place; the U.S. coffers would get more money that way.

That's right. Left unchecked, this little-known flat tax soon could be driving the country's revenue train.

Falling into AMT land
This year, you could fall into ATM land if your taxable income, combined with certain adjustments and tax preferences, exceeds the following limits:

- $58,000 if you are married filing a joint return or are a qualified widow or widower;
- $40,250 if you are single or head of household; or
- $29,000 if you are married filing a separate return.

AMT disallows all standard and many itemized deductions, taxable state and local tax refunds and intangible drilling costs. It also taxes employee incentive stock options when exercised; the regular tax system only taxes when you sell the stock.

CoIn AMT land, you'll take a 26-percent tax hit on your first $175,000 gross income, and pay 28 percent above that.

Most taxpayers who fall into AMT land do so because they have a large number of personal deductions for children or dependent parents, live in a high-tax state, or wind up with more taxable income than expected at year's end, either because of a year-end bonus, capital gains, severance package, or because they exercised incentive stock options.

Tax lawyer Robert Sommers has seen the devastating effect that the AMT has had on Silicon Valley taxpayers with incentive stock options. That's because the AMT taxes you when you exercise your stock option, not when you sell the stock.

Here's an example: You have the option to purchase company stock at $1 a share. If, at the time you exercise it, the share price is at $101; that is not a taxable event under the regular tax laws. But under the AMT, the spread -- the difference between the fair market price and what you paid for the stock -- is considered a tax preference, and thus taxed, let's say at 28 percent, or $28 per share. Now let's say the company stock plummets (think dot-com bust). Your stock drops to $5 a share. The AMT still taxes you at the spread level, $28 per share, more than five times the value of your stock.

Should you find yourself in this catastrophic situation, be sure to sell your stock in the same year that you exercise options.

"I represent six to 10 people that have had that very thing happen to them," Sommers says. "Not only was their AMT two or three times the value of their stock, their AMT was more than everything they owned, it dwarfed their net worth by two or three times because with the boom in Silicon Valley, when these guys exercised their stock, it was worth $2 to $3 million. People have had to get second mortgages, file for bankruptcy. I have heard of a couple suicides."

"You talk about a sleeper. Most people say, 'All I got was the stock; I never sold it. You're taxing me on phantom income, income I never realized.' Even though you were locked out for six months or whatever, you are still taxed on the fair market value on the date of exercise."

No sympathy for this devil

The AMT has few defenders. Because of the tax's structure, the usual tax-reduction strategies are ineffective. Accountants blanch at having to deliver the AMT news to their clients (and more professional money managers are facing the monster themselves).

Analysts also point out that the AMT is undermining the very economic incentives that IRS deductions were created to promote.

The tax dodgers it was created to thwart now make up a measly 3 percent of the growing number of taxpayers being penalized for having kids or earning stock options at work. And the few experts in this field work for high-priced accounting firms far out of reach of the average Joe.

In her January report to Congress, Nina Olson, the national taxpayer advocate within the IRS, called the AMT the taxpayer's equivalent of Public Enemy No. 1. Olson herself was blindsided by the AMT on her 2002 tax return.

The solution seems simple enough: If we risk fiscal catastrophe to scrap the AMT entirely, at least index it for inflation and give us some deductions with which to defend ourselves.

The one group that seems noncommittal on the issue is the only group that can change it: Congress. Democrats and Republicans alike have let the AMT grow from mini-me to maxi-tax. President Bush made no mention of AMT in his State of the Union address, although his tax cuts threaten to double the number of taxpayers who will be subject to it within the next six years.

Sommers says the mother of all "stealth" taxes amounts to a sneaky sleight-of-hand by which tax-slashing congressmen can wow the populace without actually decreasing collections.

"All of this is political. None of this makes any sense whatsoever. Politicians, all of them, rush out there and say we can cut your taxes," says Sommers, "but they aren't explaining that for every dollar in tax cuts, you're going to pay 90 cents in the AMT.

"They get to campaign on cutting taxes, but they don't really disrupt the Treasury because the Treasury is going to make up through the AMT whatever they just cut in the regular system. That's why they cut taxes, because they have the AMT to bail them out."

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