Strategies for Avoiding or Minimizing the Alternative Minimum Tax

When first introduced in 1969, the alternative minimum tax (AMT) was widely acknowledged to be a "rich man's tax"--a fallback tax for those taxpayers with big incomes and numerous deductibles. But because the AMT has been adjusted for inflation only twice in 30 years, it is now encroaching upon the middle class. Consider that while only 19,000 people owed the AMT in 1970, millions are paying now.¹

The mechanics of the AMT are complex. But a general understanding of how the tax works and what triggers it can help you minimize or avoid it, and even use it to your advantage.

The Other Federal Tax
The AMT truly functions as an "alternative" tax system. It has its own set of rates and rules for deductions, which are more restrictive than the regular rules. It operates in parallel with the regular income tax system in that if you're already paying at least as much under the "ordinary" income tax as you would under the AMT, you don't have to pay it. But if your ordinary tax falls below this minimum, you have to make up the difference by paying the alternative minimum tax.

The AMT can be triggered by a number of different variables. Although those with higher incomes are more susceptible to the tax, many other factors such as the amount of your exemptions or deductions can also prompt the tax. Even commonplace items such as a deduction for state income tax or interest on a second mortgage can set off the AMT.

AMT rates start at 26%, rising to 28% at higher income levels. This compares with regular federal tax rates, which currently start at 10% and step up to 39.6%. Although the AMT rates may appear to cap out at a lower rate than regular taxes, the AMT calculation allows significantly fewer deductions, making for a potentially bigger bottom-line tax bite. Unlike regular taxes, you cannot claim exemptions for yourself or other dependents, nor may you claim the standard deduction. You also cannot deduct state and local tax, property tax and a number of other itemized deductions, including your home equity loan interest, if the loan proceeds are not used for home improvements. Accordingly, the more exemptions and deductions you normally claim, the more likely it is that you'll have an AMT liability.

On the positive side, the law does allow taxpayers to apply a special AMT exemption designed to prevent the AMT from applying to those with modest incomes. For the 2013 tax year, it is $80,800 for joint filers and $51,900 for single filers. ²

AMT Red Flags
Certain circumstances and tax items are likely to trigger the AMT:

- If your gross income is above $100,000³
- If you have large numbers of personal exemptions
- If you have significant itemized deductions for state and local taxes, home equity loan interest, deductible medical expenses (AMT has a slight difference) or other miscellaneous deductions
- If you exercised incentive stock options (ISOs) during the year
- If you had a large capital gain, which may reduce or eliminate the AMT exemption amount
- If you have passive income or losses
- If you received income from private activity municipal bonds

If any of the above applies to you, you should complete the AMT worksheet when preparing your taxes. If you don't, rest assured that the IRS will. And if they find that you owe AMT, they'll add penalties and interest.

Avoiding or Minimizing the AMT
Because large one-time gains and big deductions that trigger the AMT are sometimes controllable, you may be able to avoid or minimize the impact of the AMT by planning ahead. Here are some practical suggestions.

- Time your capital gains. You may be able to delay an asset sale until after the end of the year, or spread a gain over a number of years by using an installment sale. If you're looking to liquidate an investment with a long-term gain, you should review your AMT consequences and determine what impact such a sale might have.
- **Time your deductible expenses.** Many itemized deductions are not deductible when computing the AMT. When possible, time payments of state and local taxes, home equity loan interest (if the loan proceeds are not used for home improvements) and other miscellaneous itemized deductions to fall in years when you won't face the AMT. Since they are not AMT deductible, they will go unused in a year when you pay the AMT. The same holds true for medical deductions, which face stricter deduction rules for the AMT. But also keep in mind how deferred deductions might impact next year’s tax and potential exposure to the AMT. And if you do not itemize because the standard deduction is greater than itemized deductions, but still find yourself subject to the AMT, you may want to consider itemizing, which may result in a lower AMT tax.

- **Look before you exercise.** Exercising ISOs is a red flag for triggering the AMT. What’s more, ISO proceeds (the excess of the fair market value over the strike price or exercise price) are taxable under the AMT, while they are not under the ordinary tax calculation. There are several strategies you can employ to minimize your AMT tax exposure with ISOs. First, try to exercise the options when the price is low, so that any gains will be taxed at capital gains rates when the shares are later sold. Second, stagger exercises over a number of years, so that you stay under the level that triggers the AMT each year. And third, by selling the options in the year of exercise you may be able to minimize your AMT exposure. Because ISO tax issues are complex, you should consult with your investment advisor before exercising ISOs.

### AMT Red Flags: Incentive Stock Options

When you exercise an incentive stock option, you must report an adjustment for AMT purposes. The adjustment equals the difference between the exercise price and the fair market price.

**EXAMPLE:** You exercise an incentive stock option to purchase 1,000 shares of your company's stock at $20 per share when the stock is trading at $50 per share. For AMT purposes, you must report an adjustment of $30,000 ([$50-$20] x 1,000).

- **Invest selectively in municipal bonds.** Although interest on most municipal bonds is exempt from regular and AMT tax, interest on municipal bonds that fund a private activity are taxable for AMT purposes. So if you are subject to the AMT, make sure to factor in the AMT when calculating after-tax returns on private activity bonds. Also keep in mind that the tax exemption for municipal bonds is more “valuable” if you are in the top tax brackets. Since the top AMT tax rate is 28% (compared with 39.6% for ordinary income), those subject to the AMT may find that a taxable bond will yield a higher rate of after-tax return.

- **Minimize passive activity losses.** Losses from rental real estate, tax-shelter farm activities and similar passive activities are not deductible in computing AMT income. For certain taxpayers, this can pose an issue if the passive activity loss is deductible for regular tax purposes.

- **Use home equity loans wisely.** The AMT limits the deduction on home equity loans to interest on proceeds used to purchase, build or substantially improve a principal or second residence. Amounts used for other purposes are not deductible under the AMT. This is an important point to keep in mind when using a home equity loan for other purposes, and you may wish to pursue alternate funding for such purposes if you will be subject to the AMT. You should make sure to keep accurate records of what is borrowed specifically for home improvement and keep receipts of all your expenditures.

Keep in mind that the rules and reporting associated with the AMT are complex, and the tax planning issues that relate to it are comprehensive. If you think you may be subject to the AMT, let me help you evaluate what steps you can take to avoid or minimize your exposure.

### Notes/Disclaimers

Interest in municipal bonds is generally exempt from federal income tax. However, some bonds may be subject to the alternative minimum tax (AMT). Typically, state tax-exemption applies if securities are issued within one’s state of residence and, local tax-exemption typically applies if securities are issued within one’s city of residence.

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