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Middle class vulnerable to misguided tax status

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You may be in the throes of the holiday season, but another special occasion tax season is fast approaching.

There are steps you can take before the year is out to minimize your 2006 tax liability. But if you're going to be subject to Alternative Minimum Tax, or AMT, there isn't all that much you can do.

AMT was intended to stop high-income taxpayers from taking advantage of tax loopholes, which resulted in very low tax bills. But in recent years, many middle class taxpayers, especially those in high tax states like New Jersey, have found themselves subject to AMT because the AMT exemptions have not been indexed to inflation until recently.

The most recent increase was back in May, when the Tax Increase and Prevention and Reconciliation Act increased the exemption amount for 2006 only for those married filing jointly to \$62,550 from \$58,000, and for singles, to \$42,500 from \$40,250. Unless Congress decides to make some changes, the exemption amount is scheduled to drop again in 2007 to where it was in the year 2000.

The other difference between AMT and the regular tax system is that many common deductions are forbidden under AMT.

"The only common deductions allowed under the AMT are for mortgage interest and charitable contributions," says Marnie Aznar, a certified financial planner with Aznar Financial Advisors in Morris Plains. "So even though the AMT rates of 26 percent and 28 percent may not look terrible compared to the highest rate of 35 percent for regular tax purposes, the alternative minimum tax will result in a higher tax bill since more income is taxed."

There is no one item that triggers AMT. You increase your potential liability if you face some of the following for 2006:

- Exercising incentive stock options
- Having a large number of personal exemptions (i.e. a lot of kids)
- Living in a high tax state
- Paying high real estate taxes
- Taking large deductible medical expenses
- Itemizing deductions for home-equity-loan interest (not used for the purpose of buying, building or improving a home)

- Receiving interest income on private activity bonds subject to AMT

To find out if you're at risk, discuss your situation with your tax preparer or check out the Internal Revenue Service's AMT Assistant calculator at www.irs.gov.

If AMT is in your future, consider these steps to minimize your liability:

State and Local Tax Payments

If you are projected to be in AMT in 2006, understand traditional tax planning strategies usually don't apply, says Sheri Ian netta Cupo, a CFP with Sage Advisory Group in Morristown.

For example, Cupo says it typically makes sense to accelerate the payment of state and local taxes so that you can claim the deduction sooner rather than later. But if you are subject to AMT, you can't deduct state and local taxes, so prepaying them by Dec. 31 won't help lower your tax bill.

Therefore, if you expect to be subject to AMT in 2006, consider moving payments to another year when you won't face AMT (This could mean underpayment penalties, but those fees could be less than the tax savings).

If you know you're AMT-safe for 2006, but you expect to be in AMT for 2007, consider accelerating tax payments into this year.

Property Taxes

Prepaying property taxes, or not prepaying them, can also change your AMT status. Do the math and see where you stand.

"It's easier to do if you pay your own property taxes and they are not paid as part of your mortgage payment," says Michael Gibney, a CFP with Highland Financial Advisors in Riverdale.

Incentive Stock Options

If you're fortunate enough to have incentive stock options, exercise them gradually, Aznar says.

"If you are not subject to AMT, you may be able to exercise a portion of the shares annually and still stay out of the reaches of the AMT," she says. "You should work with a qualified tax professional to ensure you exercise the correct number of shares."

Alternatively, Aznar says if you exercised these options earlier in 2006 and held the shares in an attempt to capture long-term capital gains rates on the eventual sale, and the stock price has plummeted in the interim, consider selling the shares prior to the end of the year to avoid the AMT hit all together.

Deducting Medical Expenses

Under normal tax rules, you can deduct medical expenses in excess of 7.5 percent of your Adjusted Gross Income. Not so for AMT. Under AMT rules, you can only deduct medical expenses in excess of 10 percent of AGI. Cupo recommends you bunch medical expenses into a year that you won't be subject to AMT.

Watch Mortgage Debt Interest

Cupo says only interest on mortgage debt that is used to buy, build or improve a home can be deducted by those subject to AMT. That means that if someone who pays AMT spends \$20,000 of her home equity loan on a car or to pay for college for their child, the interest on that debt is not deductible.

Capital Gains Considerations

Your line of work may allow you to defer income or bonuses into the next tax year. After you run the numbers to see where you land for AMT, consider asking clients or your boss to wait until next year to cut you a check for money you've already earned.

Plan Ahead

Remember that what you do for this year's AMT planning will have an impact on your AMT future.

"Any steps you take this year to avoid AMT may create AMT problems for next year, so be sure to look at two years at a time at a minimum when doing AMT planning," Aznar says.

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