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ADVISER FUND UPDATE

Market Summary and Commentary for Individual
Investors from Adviser Investments



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Beware the AMT

This tax season there's a three-letter acronym besides IRS that is giving taxpayers and accountants fits. It's the AMT, or Alternative Minimum Tax. The number of people who will be affected by the AMT has been poised on the edge of a dramatic leap from year to year, annually restrained by patches pushed through Congress—most recently as a \$70 billion provision covering tax year 2009 in the American Recovery and Reinvestment Act signed into law this week. Each year the number of potential payers increases, largely as a result of the 2001 and 2003 tax cuts. Under the current tax code, without annual patching—or, of lower probability, a permanent solution—33 million taxpayers will be paying the AMT by 2010 and over 43 million (or nearly two-fifths of the overall taxpaying population) will be subject to it by 2018.

Congress created the AMT in 1969 after discovering that 155 taxpayers making over \$200,000 (a princely sum in those days) had avoided paying any federal income tax. Unfortunately, the AMT was not indexed to inflation and over the years it has begun to affect more and more people. It's estimated that 4.1 million taxpayers will have to pay up under AMT rules this April, and they will owe an average of \$2,000 more than if they filed normally.

Essentially, the AMT functions in a parallel universe to the normal income tax, 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 then pay whichever is higher. Many more than the aforementioned 4.1 million people who will be subject to paying the AMT will have to take hours filling out a 14-line worksheet and then a 55-line form to figure out whether they owe it or just the normal income tax. The IRS has estimated in the past that this will take an additional 12 hours on top of the time spent calculating your income taxes (although they have maintained an abbreviated online worksheet on their website for the past several years, which can be used in conjunction with filling out your 1040 to give you an estimate of whether or not you'll need to pay the AMT in a given year, and could save you some time).

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 since 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 behooves you to do it, or to hire a professional to help you out if you're unsure about your return.

You can expect to be subject to the AMT (or at least to filling out the form) for tax year 2008 if your taxable income exceeds the exemption, which is currently \$69,950 for married couples and \$46,200 for singles and heads of households. As the law now stands, these amounts will drop considerably for tax year 2010 (there is the aforementioned provision already in place for 2009), which would cause the number of taxpayers hit by the AMT to jump to an estimated 33 million households if tax laws remain unchanged and no further patches are applied.

The people who should be most concerned about the AMT are those with children; especially two or more. According to the Urban-Brookings Tax Policy Center of Washington, D.C., by 2010, 44% of married couples with two or more children will have to pay the AMT. And for those with higher levels of income, 94% of households with income between \$200,000 and \$500,000 and 78% of households with \$100,000 to \$200,000 in income will have to pay by 2010 (over 20% of the total taxpaying population is projected to be subject to the AMT by 2010).

In the past, part of the reason that Congress and the President have been unwilling or unable to eliminate the AMT is the cost. It is estimated that getting rid of this tax would cost an estimated \$1 trillion in tax revenue over the next decade. Just applying an annual patch for tax year 2008 to keep the number of people affected by the AMT at around 4 million is estimated to cost well over \$50 billion. While the recent changeover to a Democrat-led government has provided some hope about getting rid of the AMT, it is unlikely any real change will occur until the Bush tax cuts are repealed (or allowed to expire), which would make up for the cost of eliminating the AMT altogether. But any further discussion or planning for the elimination of the AMT will likely be held off until 2010, as Congress and the President elected to follow the familiar, temporary patch route for 2009, keeping the number of households to be affected about in line with what the 2008 patch established.

However, 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—it might just put some money back in your pocket.

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

Vanguard has not elected to provide any AMT-free funds as of yet, instead limiting most funds' holdings to a max of 20% of assets in bonds with interest subject to the AMT. The reason, according to Christopher Ryon of Vanguard's Fixed Income Group, is that eliminating AMT-taxable bonds would reduce diversification and lower the yields of certain funds.

This alternate tax system is a problem for taxpayers that will keep growing each year, and regrettably, unless the government takes action, there is no simple solution. We would like to be able to give you some specific advice about how to beat the AMT, but in this case the power for change lies with Congress and the President. 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 you might not feel great about having to pay it, at least you'll have the peace of mind knowing that your taxes were correctly calculated and that the IRS won't come knocking on your door looking for more of your hard-earned cash.

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