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New Jerseyans watch out for that AMT tax bite

IT'S YOUR BUSINESS

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Q: We completed our taxes and were penalized by the alternative minimum tax. Can you explain what AMT is and why we and many of our family members who live in New Jersey have been affected?

The Problem: Alternative Minimum Tax.

While automated teller machines (ATM's) giveth, the alternative minimum tax (AMT) taketh away. The AMT was enacted in 1969 to collect taxes from the wealthy, who may have otherwise used loopholes to avoid paying taxes. Unfortunately, as incomes have gone up and the AMT has not been adjusted for inflation, the number of people adversely impacted has skyrocketed.

In 2001, 1.3 million taxpayers paid AMT. That jumped to 3.4 million last year. If Congress does not act, 25 million taxpayers will be adversely impacted this year, according to U.S. Treasury Department estimates. The average household reporting \$100,000 to \$200,000 of income would be hit with an additional tax bill of \$2,800.

AMT details.

When taxpayers calculate their federal income taxes they make sure they include important exemptions, deductions and tax credits like personal exemptions, standard deductions, property taxes, state and local income taxes and child tax credits. After the benefit of all those adjustments a taxpayer may wind up only paying 20 percent of their reported income and 15 percent on their long-term capital gains.

The same taxpayer, under AMT, would pay a flat 26 percent or 28 percent on their reported income and 22 percent on their long-term capital gains — losing out on the tremendous exemptions, deductions and tax credits listed above.

New Jersey takes the cake.

In 2004 (the most recent reported data from the Tax Policy Center), 7.6 percent of New Jersey taxpayers paid AMT — the highest percentage of any state in the U.S.

New Jersey taxpayers edged out New York taxpayers, at 7.4 percent, and more than doubled the national average of 3.5 percent. States with high state and local income, like New Jersey, are most impacted by AMT.

So what is the reward for paying high state and local income taxes, high property taxes and having a family? Unfortunately, higher federal taxes.

The Solution: Yet another patch.

Congress is likely to repeat what it has done the last few years, provide last-minute changes to limit the number of taxpayers adversely impacted by AMT.

Like the federal deficit, Medicare and Medicaid, a quick fix for AMT does not appear imminent. Fortunately, last-minute patches to AMT have significantly contained the number of additional taxpayers impacted by AMT in recent years, and will likely have the same impact this year. Let's hope, at least.

Often overlooked.

Many investors assume their municipal bonds are free from income taxes. In most cases they are, but they may not be free from AMT. Pay close attention to the type of municipal bonds you own and buy. You could be sitting on or about to buy a tax trap. Many municipal bonds and municipal bond funds are AMT-free, meaning they are not subject to AMT — even if you are subject to AMT. Carefully read the offering memorandum before investing.

Action Steps: Somewhat limited.

Unless you move to a lower income tax state, move to a lower property tax community or stop earning income, AMT is likely to impact you and your family.

If you have control over the timing of your income and incentive compensation (such as bonuses and stock options), you may want to consider delaying their receipt until next year. All things being equal, it is better to pay your taxes later than sooner. For most taxpayers, the best thing you can do is to simply prepare to pay higher income taxes. When it comes to important financial matters, speak with a financial professional before making irreversible decisions that may haunt you for years to come.

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