

505 South Third St.
Suite 300
Louisville, KY 40202
(502) 589-1772



Capital Blueprints for the Future

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The AMT Bite

A stealth tax that may kill your tax breaks.

(1) The AMT originally targeted a small group of aggressive filers who made \$200,000 or more per year and were paying zero tax. But the AMT steadily advanced into the mainstream, affecting 132,000 taxpayers by 1990, 1.3 million in 2000 and 2.4 million in 2003. If the rules are not changed, it will apply to an estimated 12.7 million taxpayers by 2005 and 33 million by 2010. That encompasses about 95% of taxpayers with incomes from \$100,000 to \$500,000—and one of every three Americans who file a return. (“Taxpayer Beware!”, *Fortune*, 23 June 2003, p. 50.)

(2) The AMT accounted for about 2% of all federal tax receipts in 2003—about \$16 billion. By 2010, the collections from this tax will equal an estimated 1% of GDP—or about \$124 billion. That’s equal to about 55% of the total income earned in the U.S.

(3) The calculation: Take your regular taxable income figured on Form 1040 and add back all deductions except mortgage interest and charitable contributions. Then subtract the exemption from AMT (eg, \$58,000 for married joint filers in 2003). The adjusted number is income subject to AMT. A 26% tax rate applies to the first \$175,000 and 28% to the remainder. If your liability under the AMT is higher than your regular tax, you pay the higher amount.

(4) Property and state income taxes are rising steeply around the country—and the trend is expected to worsen as state and local governments struggle to balance their budgets. A taxpayer can deduct state and local levies when calculating

THE TAX CUTS of 2003 have provided a welcome break for middle and upper-income taxpayers. But your tax benefits may be cut short if you fall victim to the Alternative Minimum Tax (AMT).

The AMT is a substitute tax applied to people who are lucky or shrewd enough to reduce their taxes below what the federal government deems fair. Before filing a return, you must figure this tax using a different set of income and deduction rules—and pay the amount if it exceeds your regular tax calculated on Form 1040.

When the AMT was created in 1969, only high income taxpayers who loaded up on deductions and exploited loopholes had to worry. But the AMT has been steadily consuming more and more upper-middle class taxpayers.⁽¹⁾ This tax creep has occurred for two main reasons: The program was never indexed for inflation and AMT tax rates have remained in place while marginal tax rates have dropped. As personal income and deductions have risen over the last three decades, more people have been caught in the trap.

If you make \$100,000 or more annually, pay high state and local taxes, have large job-related expenses, hold incentive stock options, or receive certain kinds of municipal bond interest, you may be exposed to the AMT. Although many consider the AMT unfair, it won’t likely disappear because the federal government cannot afford to give up the revenues in a time of rising budget deficits.⁽²⁾

The AMT operates in a parallel universe to the regular tax rules. After completing your Form 1040, you calculate the AMT using Form 6251.

You compare the taxes owed under both scenarios and pay the higher amount. Personal taxable income under the AMT typically is higher because most itemized deductions are disallowed. These include state and local taxes, property taxes, dependents, unreimbursed business expenses and

other items. Only deductions for home mortgage interest and charitable contributions survive.⁽³⁾

Although the marginal rates for AMT—26% and 28%—are lower than personal rates, the final tax often is higher under the AMT since the rate is applied to a higher adjusted income. On average, taxpayers who are caught in the AMT squeeze pay an additional

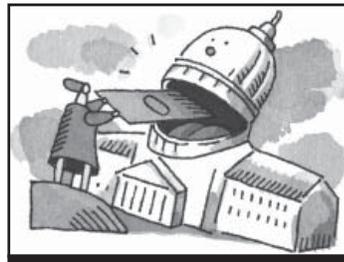
\$10,000 in tax.

To make matters worse, tax cuts in 2001 and 2003 have pushed more taxpayers into the AMT’s hazard zone. Although the laws reduced marginal tax rates in the regular tax system, the AMT brackets were not revised. Lower federal tax rates, combined with higher itemized deductions (due to rising state taxes and property taxes), may create a more likely AMT situation for a taxpayer whose income is climbing.⁽⁴⁾

Risk factors

There is no reliable method to predict exposure to the AMT. This makes annual tax planning essential. As the year unfolds, you can project total income and deductions—and consider various tax rate scenarios you may encounter. Then, take available action to avoid stepping over the AMT line. Certain risk factors will push you closer to that line. These may include:

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Work & Retirement

New Perspectives for Midlife and Beyond



Finding Your Life's Work in the "Bonus" Years of Life

In their book *Working Through Demographic Change*, Dr. Elliot Jaques and William K. Zinke wrote:

"An extraordinary change has taken place in industrialized countries during the past 50 years, the consequences of which have not been fully recognized. People are living longer and in better health, and the meaning of adult life itself has changed: a whole new stage of mature adulthood has come onto the scene, and old age has been pushed back by many years."

Despite these bonus years, many individuals retire as early as possible because there is something about their jobs or careers they don't like. Therefore, their motivation for retirement is actually to escape their work rather than to evolve to a new chapter of life. However, leaving the world of work prematurely can "rob" an individual of many intrinsic and extrinsic rewards.

If you are dissatisfied with your work life, don't grimly plod through each day counting the years and months until you can start drawing your pension. Instead, determine to make a course correction in your work life.

For inspiration, reflect on your childhood dreams. As a young boy or girl, you were frequently asked, "What do you want to be when you grow up?" Do you remember the answers you gave at five, ten, fifteen, and twenty years old? Did your answers change as you grew older? Did you abandon your heart's desire for what seemed to be a more lucrative career choice or to please someone else?

Retirement brings vital questions about work and leisure. To live a long, happy, healthy life, you must get involved in meaningful work while approaching your leisure with serious enthusiasm.

Suppose someone were to ask you that same question today, "What do you want to do when you grow up?" How would you answer? Of course, we know that you are already "grown up" physically, but the question is really digging much deeper by implying the following additional questions:

- If you could do whatever you wanted to do in the world of work, what would that be?
- Have you figured out what types of productive activities—whether paid or unpaid—would give your life meaning and purpose?
- Have you discovered your life's work?

For many individuals, "retirement" has become an opportunity to revisit these questions—a second chance to consider what it is to "make a life" in contrast to making a living. Instead of "not working," retirement has come to mean emancipation—freedom to do the kind of work (paid or unpaid) you find most meaningful and freedom to enjoy the lifestyle you find most fulfilling.

Adults Must Learn How to Play in Meaningful Ways

JUST LIKE CHILDREN, adults need to play. Playfulness brings a lightness to life that is invaluable to our well-being. It greatly increases enjoyment of life and nourishes one's sense of humor and spirit of optimism. Therefore, you need to make sure that your leisure activities feel like play, are of your own choosing, and make you happy.

When you follow this criteria, the benefits of leisure will spill into all areas of your life. For example, your leisure activities will relieve stress, clear your mind, and improve both your physical and emotional health. In addition, shared leisure activities can enhance your relationships.

In *The Three Boxes of Life*, author Richard Bolles wrote that your leisure is what you do when no one is telling you what to do. It is his belief that any activity can be a leisure activity "if you choose it freely and truly enjoy what you are doing."

For some people, choosing "meaningful" leisure activities is a contradiction in terms. That is because they associate the word meaningful with activities that have a serious purpose. However, leisure activities can most definitely be meaningful to you if they bring you enjoyment and are truly effective in refreshing your body, mind, and spirit. Bolles wrote:

"The most important thing about your leisure time is not what you do with it, but the spirit with which you approach it. By making your leisure the place where you preserve a spirit of leisureliness in your life, you will not only enjoy life more—you will prolong it." ■

Living With Volatility

Turbulence is the rule, not the exception, with stocks.

ALTHOUGH THE STOCK MARKET reflects economic forces that move in cycles, stocks don't behave predictably or tamely most of the time. This is the nature of market volatility.

Investors fool themselves if they view the stock market as having a "normal" state with occasional extreme movements. History doesn't support this. In fact, the opposite is true.

The S&P 500 Index's long-term average return is about 10% per year. This often-quoted fact leads many to expect performance to fall within a moderate range of 10% in most years. But this is not the case. Since 1925, the market has returned between 0% and +20% per year only about 30% of the time. In the other 70% of the years, the index has delivered a total return on either side of this range—above +20% or below 0%.⁽¹⁾

Extreme short-term moves are common in the U.S. market. Although investors dread this volatility, it accounts for a large portion of their total return. Like their root causes, big market moves in either direction are not easily foreseen. The events surprise investors and create stress. Some investors are prone to desperate reactions that can destroy wealth.

Random behavior

Markets are subject to many forces not easily measured or identified. A rare or inconceivable event can instantly change the prospects of companies, industries and economies. Moreover, the variables driving stock prices are not always subject to narrowly defined limits.

The stock market shows a relatively normal distribution curve when measured over a longer time span, such as a five or 10-year performance period.⁽²⁾ But on a daily, monthly or yearly basis, price movements appear to be random. People are caught off guard by unexpected, abrupt changes, as well as recognized trends that extend beyond a normal range.

For instance, people were surprised by how far volatility could carry the market upward beyond all familiar measures in the late 1990s. Then they were shocked by the downside volatility of a vicious three-year bear market. More recently, investors who accepted the logic of a lower equity risk premium in future years, were again surprised when the market strongly rebounded in 2003.⁽³⁾ These events, like others in the past, defied popular opinion and punished those who failed to keep a long-term view.

Accepting the unknown

So, volatility is the norm, not the exception. Investors who accept this reality and plan for it are better equipped to survive the short-term chaos and build wealth over time. Perhaps you can see volatility as confirmation that the capital markets are functioning.

First, stock volatility reflects the creative destruction at work in the economy. Businesses must endure cycles of expansion and contraction to survive and prosper. In the long run, this struggle leads to strong, adaptable companies, a flexible job market, innovative products and services, a rising living standard and a resilient economy.

Uncertainty also offers high potential rewards to people who are willing to take risk and manage it wisely. Volatility makes diversification and discipline powerful allies of the investor. Everyone knows that the business cycle affects company fortunes, but no one can develop a reliable method to make investment profits based on that information. Charts, computers and mathematical models have limited value in forecasting stock returns.

It's long-term investing and flexibility that counts. Investors with a well-designed portfolio can endure the volatility and position for future gain. Over time, the market's ebb and flow creates diverging prices and new opportunities. But you must be invested to grab them. ■

“Notable Quotes”

In Financial Life Planning

“In personal financial management, the place to begin is to adopt a realistic perspective. Money will only improve the quality of your life when it is used with clarity. Only when you learn to spend money in concert with your underlying values—the things that you most deeply care about—will it become a tool for creating a more fulfilling life.”

Karen Ramsey
Everything You Know About Money Is Wrong

“If you are working long hours now trying to accumulate more ‘stuff’ or more money at the expense of family, friendships, and your health, it's unlikely you'll be able to buy them back later on. So stop looking at preparing for a secure retirement as just stashing away as much money as possible. Diversify your retirement portfolio by building your investments now in people, your health, and all the other things that truly make up the good life.”

Marc Eisenson, Gerri Detweiler & Nancy Castleman
Invest in Yourself: Six Secrets To A Rich Life

“Instead of absorbing an obsolete view of retirement, we should consider what I call your ‘New Prosperity.’ This includes a flexible life plan that provides for your financial, vocational, physical, emotional, and spiritual needs. Unless you look at your future holistically, merely saving up a pile of money will be a meaningless act.”

John F. Wasik
The Late-Start Investor

(1) Looking at rolling ten-year periods in U.S. market history, the calmest 10-year interval was 1963-72, when the market swung 34% from its lowest to highest point. The largest differential came in 1929-38, when the market swung 97%. The average swing for all 10-year periods is 57%. (“Volatility, the Good Kind”, Forbes, 23 June 2003, p 162) (2) A bell curve or normal distribution curve illustrates the principle of averages. Most outcomes in nature cluster around an average, with extreme outcomes becoming increasingly rare the farther they are from the mean. (“No Such Thing”, Bloomberg Wealth Manager, June 2003, pp 37-41.) (3) The equity risk premium reflects the higher incremental return that investors require to hold stocks rather than a stable value investment, such as government bonds. The historical equity risk premium, which has averaged 4.8%, reflects the higher volatility of equities over Treasury bonds.

AMT Bite (Continued)

- **Itemized deductions.** It bears repeating: Most ordinary tax deductions don't apply in the AMT formula. Exposure increases if you are married, have several children, pay high state income and local property tax, and have other large deductions, such as unreimbursed business expenses.

- **Income level.** Beware if your income has risen sharply. The AMT exempts the first portion of income.⁽⁵⁾ But this exemption phases out, beginning at \$150,000 for married couples and \$112,500 for singles. For every extra dollar earned, it phases out 25¢. So, in 2003, the exemption disappears at \$382,000 for marrieds and \$273,500 for singles.

- **Dividends and capital gains.** The new 15% rate on dividends and long-term gains applies in the AMT. But you get less benefit as your income rises. If you have hit the phaseout range described above, each additional \$1 capital gain adds \$1.25 to the AMT income on which you will be taxed.

- **Incentive stock options.** Under the normal IRS rules, you can exercise stock options, hold the stock for a year and pay 15% gains tax when you sell the stock. However, you must report an adjustment of your paper gain when the options are exercised. This can trigger the AMT. And if the stock price plummets before you sell, tax is owed on the price at the time of exercise. Avoid this by exercising smaller amounts and selling enough to cover your taxes. ■

federal income tax. This benefit has mitigated the effect of higher taxes. But these deductions are not allowed under the AMT. People who are exposed to the AMT take a double hit: They pay higher federal tax and feel the full burden of rising taxes at the local and state levels.

(5) In 2004, the AMT exemption drops from \$58,000 to \$45,000 (married joint filers), and from \$40,250 to \$33,750 for single filers. ("The Tax of Unintended Consequences", *Money*, 8 Sept. 2003, p 89.)

This is a summary of the Alternative Minimum Tax (AMT) and is not intended to address all relevant facts, details and exceptions relating to the tax rules. Seek out qualified tax counsel to help review your current situation and to assess how the AMT may influence your decisions.

In My Opinion . . .

Robert J. Cole, Jr., CLU, ChFC, CFP™

Thoughts from the Sunshine State...

As I sit here typing this, I am listening to Latin salsa music on the radio and feeling the warm breeze of the South Beach weather blowing through my open window.

I am on my annual winter trip to Miami Beach. I have several clients here in Miami, and they provide an excuse for me to come down and spend a long weekend. South Beach is an interesting place. It is alive with the energy of the people who visit here. You can see just about anything here—from the movie stars who spend thousands of dollars going out for one night, to the beach people who sleep on the beach of the Atlantic Ocean. There is plenty of money spent in this neighborhood—a dinner for two can easily run above \$250. It is interesting to watch people manage their money in such a place. Many times the flashiest people are the ones who have the least amount. This is also a place that worships youthful beauty—which is ironic because just ten years ago it was a retirement community for the elderly.

So many of Florida's population are retired, that it's easy to forget the amount of money that is on The Gold Coast. One visit to the giant shopping malls reminds you how much money is here, since every major retailer has multiple stores. In fact, the whole place seems geared to helping you spend your money. I am sure it's a lonely place for a person with no money, but it is equally a lonely place for people with lots of money, but nothing to do with it.

So how do you balance the desire to be vibrant and manage your resources? I think it starts by building your skills early and then you won't be so easily influenced by the outside pressure designed to get you to spend. You need to be clear about your values and what you are willing to spend to support them. South Beach is a place obsessed with designer labels, famous chefs, and the latest in pop music. Yet, for all of this attention, no one seems to be satisfied. Everyone appears to be looking outside themselves for fulfillment. The sages have taught us that true fulfillment comes from an internal sense of confidence. That confidence comes from many sources, one of which is having adequate resources (money, health, relationships, etc). The true investments in life build those resources.

Don't get me wrong, I enjoy visiting the fantasy world of South Beach. It's fun to see all of the activity and the "beautiful" people. Still, three days is about all I can take. After that, I want to return to the "real" world and all the "normal" things that go with it. Now there's some true wealth!!

Until next time, that's my opinion.

Robert J. Cole, Jr., CLU, ChFC, CFP™
President