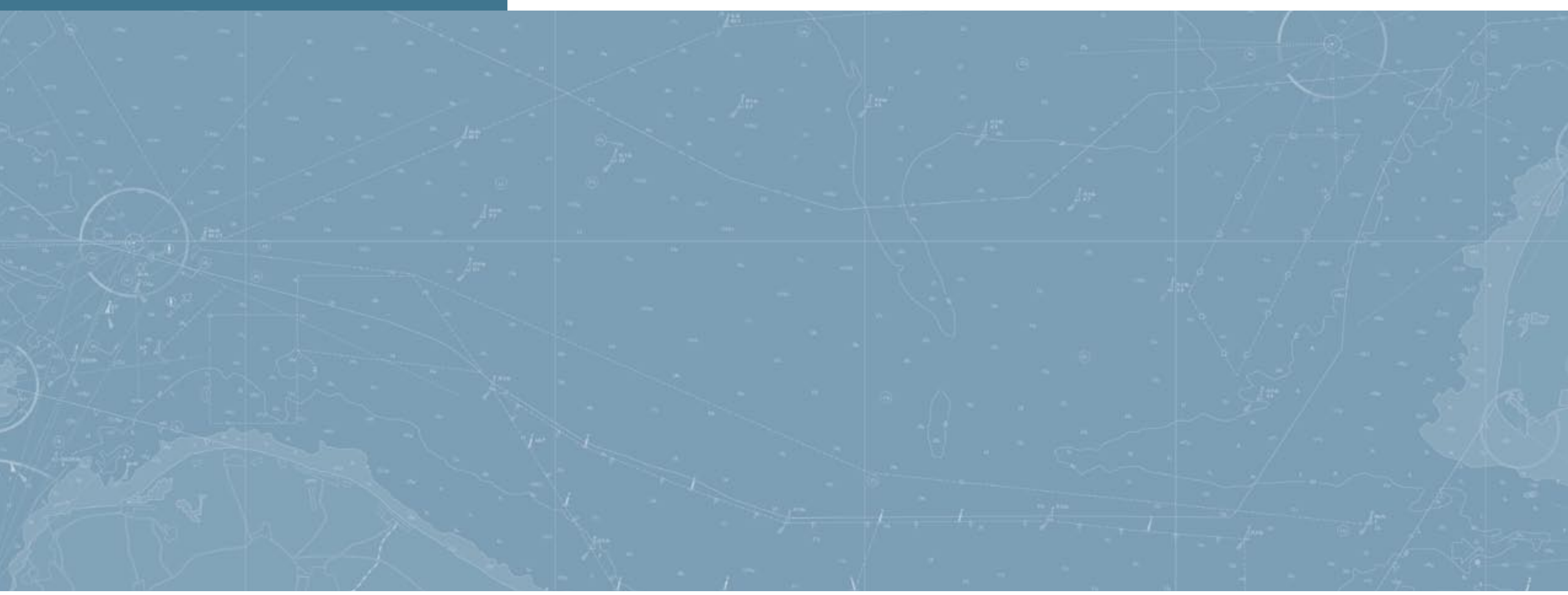
Alternative Minimum Tax (AMT)

a guide for advisors and their clients

October 2006



PIONEER Investments®

A Stealth Tax that Surprises Investors

Nobody likes to get slammed with unexpected taxes. But that's exactly what's happening to millions of Americans. And their numbers increase every year.

Everyone knows about the regular federal income tax system. But many are unaware of the federal alternative minimum tax (AMT), a second, more onerous tax calculation that hit almost 4 million Americans in 2004 with higher taxes than they would have paid otherwise. That number is projected to rise dramatically over the next decade. Almost half of U.S. taxpayers, who will file an estimated 25 million-plus returns, will be subject to the AMT by 2015 unless Congress legislates changes in the tax code. (See Exhibit 1).

Investors and their advisors need to be aware of the AMT because it has the potential to significantly reduce the effective rate of return on a portfolio. Instead of paying 15% on capital gains, effective tax rates can top 21%, according to a study by two Wake Forest University accounting professors.[1]

Pioneer Investments presents this paper to help financial advisors and their clients recognize when the AMT may strike and present options for managing AMT exposure. One important option to reduce the potential hit from the AMT is investments in municipal bonds and municipal bond funds that are exempt from the AMT. Many investors may not be aware that they can use these investments to help retain more of their investment income if they are otherwise subject to the AMT.

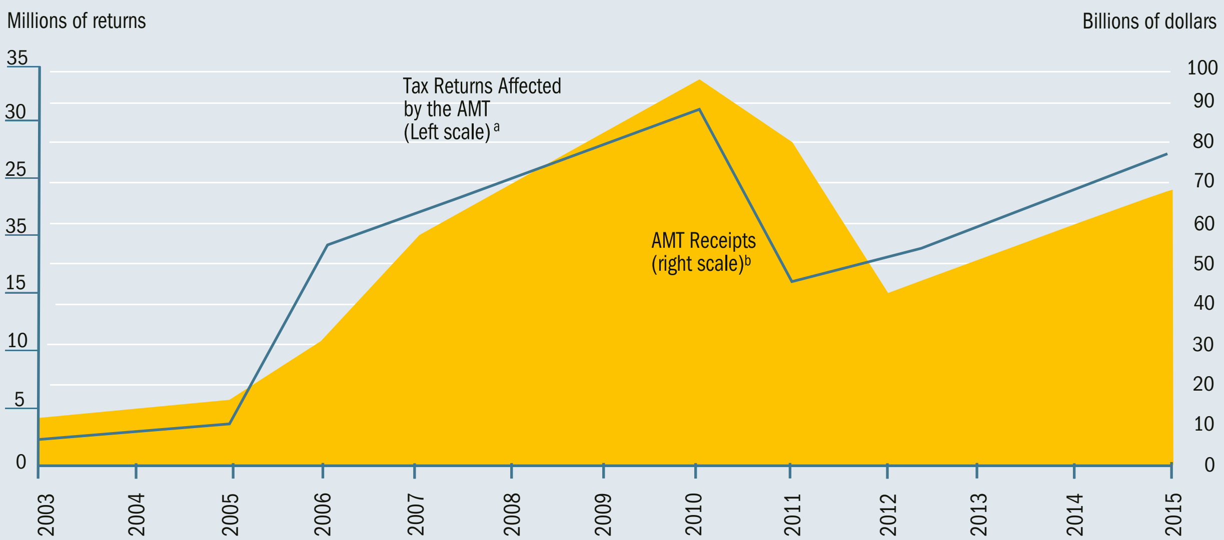
Financial advisors can help investors deal with the AMT by:

1. Alerting investors to warning signs of AMT vulnerability
2. Helping AMT taxpayers choose between investing in municipal bond funds that invest in AMT bonds, or municipal bond funds that are AMT-free—that is, they avoid bonds subject to the AMT.
3. Alerting non-AMT taxpayers about the potential for better after-tax yields from AMT bonds.

[1] Yvonne L. Hinton and Ralph B. Tower, "Influence of Long-Term Capital Gains on Individual AMT, Tax Notes, January 19, 2004.

Exhibit 1:

Projected Effects of the Individual Alternative Minimum Tax



Source: Congressional Budget Office. a. Calendar year basis. b. Fiscal year basis.

The AMT: A Tax for the Wealthy Diverges from its Creators' Intentions

The AMT started in 1969 as a way of preventing the wealthy from completely evading federal taxes. The AMT system was created after Congress learned that 155 of the nation's wealthiest taxpayers had completely avoided federal income taxes by legally exploiting the numerous loopholes and deductions in the tax code.[2]

The idea behind the AMT was to require at least a minimum level of taxes on the wealthy, while sparing the middle class from any extra burden. However, during the last decade, the impact of the AMT started spreading. In 2001, the AMT snared 1% of taxpayers. By 2015, the Congressional Research Service estimates it will snare almost half of all taxpayers![3]

Many of the new vulnerable have annual incomes between $75,000 and $500,000.[4] A key reason for this is inflation. The "regular" tax system makes annual inflation adjustments for tax brackets, exemptions and standard deductions. But under the AMT, brackets and exemptions are not annually adjusted, which means that people whose income has grown with the economy enter the dreaded AMT zone each year.

2 Leanord E Burman, William G Gale, Jeff Rohaly, and Benjamin H Harris, "The Individual AMT: Problems and Potential Solutions, TPC Discussion Paper No.5, Tax Policy Center, 2002.

3 Gregg Esenwein, "The Potential Distributional Effects of the Alternative Minimum Tax," CRS Report for Congress, RS22200, 2005, p.3. Esenwein, "The Alternative Minimum Tax (AMT): Income Entry Points and 'Take Back' Effects," CRS report RS21817, p. 2.Esenwein, CRS report RS21817, p.3.

4 Yvonne L. Hinton and Ralph B. Tower, "Influence of Long-Term Capital Gains on Individual AMT", Tax Notes January 19, 2004.

Exhibit 2:

Checklist for AMT Susceptibility[5]

How can one tell if one might become subject to the AMT? It may be a factor of whether your tax return includes one or more of the triggers listed below.

Personal

The more deductions/dependents you have, the more vulnerable you become to AMT.

- ☐ Married filing jointly
- ☐ Large number of dependents

Expenses

Large deductions for major expenses can be an AMT trigger.

- ☐ High state income taxes (see Exhibit 3)
- ☐ Interest on a home equity loan not used for home improvement
- ☐ Many miscellaneous itemized deductions

Unearned Income

The following sources may be counted as income under the AMT.

- ☐ Private-activity municipal bonds
- ☐ Long-term capital gains
- ☐ Dividends

Other

The AMT may capture taxpayers who receive income from unusual sources such as stock options or use methods to reduce or shelter income.

- ☐ Exercise and holding of incentive stock options
- ☐ Business owners with large depreciation deductions or net operating losses
- ☐ Certain tax credits
- ☐ Certain tax shelters

5 Sources for this sidebar include Esenwein, RS22200 and "Top 10 Things that Cause AMT Liability," Fairmark.com; and, "Alternative Minimum Tax (AMT): will you be one of the millions caught by it?" PriceWaterhouseCoopers, 2004.

Clearly the AMT has changed from being a tax targeted at the wealthy to one that now afflicts a broad range of upper-income and middle-class taxpayers. At the very least, the AMT adds complexity to tax returns since all taxpayers must calculate their tax using both the traditional method and also using a separate set of rules that apply to the AMT.

A wide range of factors can increase susceptibility to the AMT. Especially vulnerable are people with annual income over $75,000 and large deductions. Most vulnerable are taxpayers with multiple children, interest deductions from second mortgages, capital gains, high state and local taxes, and incentive stock options.

A checklist that identifies some of these factors is in Exhibit 2.

Taxpayers in some states tend to be more susceptible to the AMT than taxpayers in other states because the high state taxes they pay may not be deductible under the AMT. For a list of the top-10 states for AMT liability see Exhibit 3.

Exhibit 3:

Top 10 States for AMT Liability by Percentage of Taxpayers Liable
as of tax year 2003

1	New Jersey	6	Massachusetts
2	New York	7	Maryland
3	Connecticut	8	Rhode Island
4	District of Columbia	9	Minnesota
5	California	10	Oregon

Source: Gregg Esenwein, “Alternative Minimum Taxpayers By State,” CRS Report RS22083 (March 17, 2005).

Investors and their advisors need to be aware of the AMT because while capital gains and dividends are not a direct target of the AMT, the extra income earned from investments can make them subject to the AMT. The effective rate of return on those investments can change significantly as returns increase.

The chart below shows the impact of the AMT on effective rates of return on long-term capital gains. It is also important to note that state tax rates on long-term capital gains can also sharply increase the effective tax rate on long-term capital gains.

Exhibit 4:

Influence of AMT on Long-Term Capital Gains Tax Rates

Net Long Term Capital Gain	0	30,000	50,000	100,000	200,000
Total Adjusted Gross Income	178,001	208,001	228,001	278,001	378,001
Taxable Income	144,584	175,484	198,524	256,124	362,500
Regular Tax	29,762	34,514	38,365	47,993	65,712
AMT (additional tax above regular tax)	0	1,693	2,142	3,264	5,119
Total Tax	29,762	36,207	40,507	51,527	72,757
Effective Tax Rate on LTCG	**0%**	**21.48%**	**21.49%**	**21.50%**	**21.50%**

Source: "Influence of Long-Term Capital Gains on Individual AMT, by Yvonne L. Hinson and Ralph B. Tower, Tax Notes, Jan. 19, 2004. Note: Data is calculated for 2003 tax year. 2006 tax calculations may be different.

Investment Strategies for Minimizing the Impact of the AMT.

How could investors use municipal bond funds to help manage their exposure to the AMT?
Municipal bonds are an important option for investors subject to the AMT because of their tax-free status.[6] But not all municipal bonds – and municipal bond funds — are the same. The reason: some municipal bonds, and the funds that invest in them, are subject to AMT taxes. This is because the AMT requires a different tax treatment when the bond is deemed to be financing for a private activity, such as a housing project, hospital, or industrial park.

If you received $5,600 in tax-free interest every year through a $100,000 investment in a municipal bond, the AMT could take more than 25% of that amount to taxes.[7]

Some municipal bond mutual funds do not invest in AMT bonds. These are known as AMT-free municipal bond funds, and their goal, while not necessarily guaranteed, is to try to ensure that the income they generate for their shareholders is not subject to the AMT, thereby preserving the tax-free nature of the income for all investors.

It's important for financial advisors to be aware of these tax issues and warn their clients. In brief, if an AMT bond and a non-AMT bond offer the same yield, the investors subject to the AMT will earn less on the AMT bond.

It may seem like an easy decision for an AMT taxpayer to choose an AMT-free fund. But there's an important wrinkle. AMT bonds often have higher yields than non-AMT bonds of comparable quality and maturity. That difference can mute

[6] "Those "Tax Free Munis: Look Again," BusinessWeek magazine, Feb. 16, 2004.
[7] For illustrative purposes and not representative of a specific investment. A portion of income may be subject to local, state, federal, and/or alternative minimum tax. Capital gains, if any, are subject to a capital gains tax.

— or even wipe out — the advantage of an AMT-free fund. In some cases, however, the opposite is true. The slightly higher yield advantage of AMT bonds may not be enough to overcome the AMT tax hit.

AMT bonds have potentially higher yields for three reasons:

1. They may be of lower credit quality
2. Investors demand a higher yield as an incentive for taking a chance that they may someday be subject to AMT and be assessed the AMT tax.
3. They need to offer higher yields to compete on an after-tax basis with non-AMT bonds

Lower credit quality means there's a greater risk associated with the bonds. However, the risk of default is low, since municipal bonds rarely default. But extra risk isn't necessarily bad when you're reaping higher yields. A key consideration is the ability of the portfolio manager to conduct rigorous credit analysis and identify pricing anomalies. A strong team of credit analysts can help the portfolio manager identify candidates for investments that are lower-rated, higher-yielding bonds with strong fundamentals.

If an AMT-free fund makes sense for an investor, how can one identify good candidates? The major fund ranking services do not provide a category for AMT-free funds. Some funds have been renamed to include "AMT-Free" in the name. Still, financial advisors may need to comb through prospectuses and semiannual reports for the details since not all AMT-Free funds invest only in AMT-free bonds.

Another complication is that funds that appear to be AMT-free today may not remain AMT-free tomorrow. Unless its prospectus limits the fund to investing only in non-AMT bonds, its AMT holdings could go from zero to a significant percentage.

A Word About Risk

A portion of income may be subject to local, state, federal, and/or alternative minimum tax. Capital gains, if any, are subject to a capital gains tax.

When interest rates rise, the prices of fixed income securities in the fund will generally fall. Conversely, when interest rates fall, the prices of fixed income securities in the fund will generally rise.

If the Internal Revenue Service determines an issuer of a municipal security has not complied with applicable tax requirements, interest from the security could become taxable and the security could decline significantly in value.

Investments in the fund are subject to possible loss due to the financial failure of issuers of underlying securities and their inability to meet their debt obligations.

Exhibit 5:

Factors to consider when evaluating Municipal Bond Funds and the AMT financial advisors and their clients should consider several key questions when considering whether to invest in a municipal bond fund with AMT exposure or AMT-free municipal bond funds.

Investor Q & A

Q. Is the potential higher yield advantage of the municipal bond funds with AMT exposure wiped out by the AMT tax hit on the investor?

A. If yes, consider AMT-Free municipal bond fund.

Q. Are higher yielding municipal bond funds with AMT exposure more attractive than AMT-free municipal bond funds after paying the AMT tax?

A. The answer requires careful consideration of the circumstances of individual investors. If the AMT hit is small, consider a municipal bond fund with AMT exposure.

Q. Despite the higher after-tax yield of a municipal bond fund with AMT exposure, is the investor concerned about the slightly lower credit quality of the AMT issues and therefore the higher risk profile of the fund?

A. Consider that the long-term default rate for municipal bonds is below 1%. However, if the investor's goal is to minimize risk at the potential expense of yield, consider an AMT-Free municipal bond fund.

Q. Is the portfolio manager of the municipal bond fund with AMT exposure backed by a strong in-house credit research team capable of assessing the risk of different municipal bonds and evaluating pricing anomalies in the market?

A. If no, consider a higher quality AMT-free municipal bond fund.

Outlook for AMT Reform

Won't Congress eliminate – or adjust – the AMT now that it is hitting less affluent taxpayers? That would spare advisors and investors all of this complicated strategizing about taxes.

The answer: The U.S. government would lose too much revenue if it eliminated the AMT.

"It will soon be less expensive to repeal the regular income tax than to repeal the AMT," according to the Congressional Research Service. Even more limited steps, such as extending the increase in the AMT exemption, would be costly.

Congress has proposed many measures to reduce the AMT's impact on individuals. Many experts expected some sort of relief to pass in 2006, but even that might offer only one year of relief.

Conclusion? The AMT is unlikely to disappear completely in the near future.

Before investing, consider the product's investment objectives, risks, charges and expenses. Contact your advisor or Pioneer Investments for a prospectus containing this information. Read it carefully.

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