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## Enter the 'AMT-Free' Zone

### Mutual Funds Pitch To Investors: Avoid This Complex Tax

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As the alternative minimum tax hits more taxpayers, mutual-fund companies are pushing products that promise to help investors avoid this complex tax.

Fund companies are rolling out new "AMT-free" funds, which invest in municipal bonds and money-market instruments whose income isn't subject to the AMT, and changing the names of existing funds to emphasize the fact that they avoid investments that are subject to the tax.

Wall Street's **Goldman Sachs Group** Inc. launched its first AMT-free mutual funds late last year. Fidelity Investments expanded its roster of AMT-free funds last year and adjusted the names of some existing funds to label them as AMT-free. Pioneer Investments earlier this year changed the names of two of its funds to highlight the fact that they're AMT-free. And OppenheimerFunds is running an end-of-year direct marketing campaign calling investors' attention to the AMT and advertising one of its AMT-free funds in airports in upstate New York.

The decision to buy AMT-free funds can be complex, and investors hoping to avoid the AMT must choose their funds carefully. Investors often don't know if they're subject to the AMT until they prepare their tax returns in March or April, when it's too late to adjust the type of investment income they've received during the tax year. What's more, municipal bond funds vary widely in their AMT exposure, and AMT-free funds aren't always clearly labeled. Municipal bonds exempt from the AMT generally offer lower yields than munis that are subject to the tax.

The AMT, whose origins date from 1969, is an alternative tax system designed to ensure that wealthy individuals pay at least some income tax. Though Congress has enacted a series of temporary fixes that have limited the number of people paying the AMT, the tax has been affecting a growing number of taxpayers in recent years, partly because it isn't adjusted for inflation.


### Sidestepping the AMT

A growing group of mutual funds invest primarily in municipal bonds whose interest income is exempt from the alternative minimum tax. Here's a sample of some of the offerings.

FUND	ONE-YEAR RETURN	THREE-YEAR ANNUALIZED RETURN	EXPENSE RATIO
Eaton Vance AMT-Free Municipal Bond	9.0%	6.2%	0.87%
Fidelity Tax-Free Bond	5.6	4.8	0.17
Oppenheimer AMT-Free Municipals	8.4	8.3	0.87

Major factors that can trigger the AMT include high state and local taxes and personal exemptions such as having dependents. About 3.5 million taxpayers will be affected by the AMT in 2006, up from 2.5

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Note: As of Dec. 14

Source: Morningstar

million in 2003,  
according to the Tax

Policy Center, a research group. If Congress doesn't enact another fix for 2007, more than 23 million taxpayers could be affected.

Municipal bonds are typically issued by state and local governments to pay for public projects like bridges and schools. They are a popular investment option for tax-sensitive investors, because income from these bonds is generally exempt from federal and state tax in the state where they're issued. But not all munis are exempt from the AMT. When the bonds are issued to pay for "private activities," which might include housing projects or airport facilities, investors who are subject to the AMT must pay taxes on the income.

Investors hoping to avoid the AMT must choose their municipal bond funds carefully. Last year, the average muni bond fund portfolio had nearly 90% of its holdings devoted to AMT-free bonds, according to Lipper. But this percentage can vary widely. As of the end of November, for example, more than 40% of the assets in the Fidelity California Municipal Money Market fund, which doesn't promote itself as AMT-free, were in holdings subject to the tax. What's more, many muni bond funds whose prospectus identifies them as AMT-free are allowed to invest as much as 20% of assets in municipal bonds subject to the AMT, though managers generally say they avoid these holdings completely.

To be sure a fund is AMT-free, investors should read the prospectus and call the fund company, advisers say. Investors also should consider their tax situation carefully before buying in to these funds, advisers say.

Since AMT-free muni bonds offer lower yields, investors who don't have to pay the AMT are "giving up yield for no reason," says Robert Gordon, president of brokerage firm Twenty-First Securities Corp. In the case of 10-year muni bonds with a 5% coupon, issues that are subject to the AMT yield roughly 3.9%, or about 0.23 percentage point more than comparable AMT-free munis, according to Thomson Financial. As more people become subject to the AMT and demand AMT-free bonds, bidding up the price of these investments, some money managers expect the yield gap to grow even wider. (Bond prices and yields move in opposite directions.)

If the tax rules don't change, "more and more people are going to be captured by the AMT and more and more people are going to be avoiding AMT bonds," says Bob MacIntosh, co-director of municipal investments at Eaton Vance Corp.

If there's a chance you might have to pay the AMT, many financial advisers recommend sticking with AMT-free funds. "The best defense is just to get prepared in advance and only buy funds that have no AMT," says Don Martin, a financial planner in Los Altos, Calif.

Many congressional leaders have said they intend to take a hard look at the AMT, raising the possibility that the tax could be scaled back or repealed altogether. However, such a move, which would cut deeply into government revenues, isn't likely soon.

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