ISOs Meet The AMT: Employees Ambushed by the Tax Code

By Robert L. Sommers

The following article appeared in the June 18, 2001 edition of Tax Notes, published by Tax Analysts, Volume 91, Number 14, page 2055, in substantially the same format.

TABLE OF CONTENTS

SUMMARY OF THE PROBLEM

The New Economy[1] plays by new economic rules and uses new forms of compensation. Cash plus an interest in a company lures millions of employees to work 60 to 80-hour weeks for years, in hopes of a huge payoff. Workers gladly receive company stock options[2] because if the company goes public[3] their options could instantly be worth millions – or so they thought. In March 2000, when the NASDAQ bubble burst, even the strongest companies in America were not spared the collapse.

These workers understood their stock could lose value and, just like every investor, they accepted the financial risk by holding their company's stock. But many failed to notice that an antiquated tax system was ready to pounce on them, once they exercised their options. Some paid withholding taxes upon exercise; many found out only when their tax returns were prepared the following year.

Unlike investors who purchase stock, employees are taxed on the "spread"[4] when they exercise their options, not when they sell their stock. Rules developed 30 years ago to ensure the wealthiest would pay their fair share of taxes, roared-up and bit these workers, without regard to their level of income or job title – from president and CEO, to secretaries and receptionists – no one was spared.

Rules enacted to tax employee stock options upon exercise failed to provide safeguards in case that stock's value plunges before it was sold. Our tax system, which usually taxes a transaction when there is a sale or disposition, not when an asset is received, failed these workers and as a result, many now owe more in tax than their stock is worth; indeed, many owe more in tax than their entire current net worth.

1 EMPLOYEE STOCK OPTIONS – THE NEW GOLD RUSH

1.1 Jeff Accepts a Job in the New Economy

Jeff, a bright, young computer engineer, went to work in Silicon Valley and took a job as a computer-chip designer for a start-up called Granite Systems. He had no idea that the incentive stock option (ISO) he received would cause his financial ruin. Jeff, as many workers in the New Economy, was prepared to work 60-80 hours a week in return for the opportunity to make huge profits if his company went public.

---

[1] The New Economy refers to high-tech and Internet companies involved in creating or using the latest technologies. These companies are either start-ups designed to go public or are companies listed on the NASDAQ.

[2] An option is the contract right to acquire a certain number of shares at a stated price per share for a fixed period of time. Employee stock options provide workers an opportunity to share in a company's financial success by permitting them to purchase the company's stock at a favorable price (at least in theory). Usually, conditions are attached to the exercise of stock option, ensuring that the employee will work for the company for a minimum number of years.

[3] Going public refers to the company's initial public offering ("IPO") of stock on a publicly traded stock market. When a company has a successful IPO, its stock value can skyrocket.

[4] The "spread is the difference between the fair market value of the underlying stock at the time of exercise and the option price paid.

Jeff received an option to purchase 80,000 shares at $0.05/share when the stock was worth $0.05/share. Jeff understood that his option would "vest" over a 4-year period.[5] About three weeks after Jeff joined Granite, the company was acquired by CISCO, which continued Granite's employee stock option plan, adjusting Jeff's options accordingly.[6] Now, incredibly, Jeff owes $1 million more in taxes than his stock is worth and he is financially insolvent.

Jeff's story is being replicated throughout the country. It is an example of how a tax monster called the Alternative Minimum Tax (AMT) is thrashing the lives of many workers, from corporate officers to the rank-and-file, throughout the New Economy. Here is what happened:

1.2 Jeff Exercises his Stock Options

In March 2000, Jeff exercised his options in CISCO. This was consistent with the prevailing wisdom of exercising in the first 3 months of the year to obtain long-term capital gains (LTCG) treatment if one sold the shares at least 12 months later. Proceeds could be used to pay taxes due April 15th of the following year.

When Jeff exercised his options, no warnings were issued; Jeff received no notice from his employer pertaining to his potential AMT liability and no taxes were withheld. However, Jeff had just triggered the dreaded AMT, which is calculated at the stock's price on the date of exercise, regardless of the stock's price in the future. When Jeff exercised his options, his stock was worth an average of $65/share. If he sold the stock within 12 months of exercise (or within 24 months of grant) he would have made a "disqualifying disposition" and paid ordinary income tax at a maximum federal rate of 39.6%. If he held the stock for at least 12 months before sale, his maximum federal tax rate would be 20%, nearly 50% less.

By March 2001, CISCO's stock was languishing below $20/share, a drop of more than three times the stock price when Jeff exercised his ISO.

1.3 Incentive Stock Options

Jeff received an ISO, a special type of stock option reserved for employees under IRC Sec. 422.[7] An ISO provides a tax incentive to employees who remain employed by their companies because, supposedly, they are not taxed upon exercise, and a later sale of the stock qualifies for long-term capital gain treatment.[8] In, 1981, the Senate Finance Committee provided the following justification for an ISO:

---

[5] Jeff's option was subject to a typical four-year "earn-out" provision in which he would own ("vest") 25% of the option after 12 months of service, and then 1/48 per month for months 13 through 48.

[6] The merger called for CISCO to issue 0.221992 shares of its stock for every share of Granite's stock, so Jeff's ISO was reduced from 80,000 shares at $0.05/share to 17,759 CISCO shares at an exercise price of $.2252/share. At the time, CISCO's shares were trading at approximately $60/share, so Jeff's spread instantly jumped to $1,065,540. Subsequently, CISCO's stock split 3:2 in December, 1997; 3:2 in September, 1998; 2:1 in Jun 99 and 2:1 in March, 2000. After the splits, Jeff had 159,831 shares with an exercise price of $0.025/share.

[7] Incentive stock options are also called "statutory options" because they must meet the requirements of IRC Sec. 422.

[8] IRC Sec. 421(a). Long-term capital gain treatment is accorded, provided the employee does not sell the stock for at least two years from the date the option was granted and one year from the date the option was exercised. In addition the employee, in general, must remain employed with the company during this period and the option

> The committee believes that reinstitution of a stock option provision will provide an important incentive device for corporations to attract new management and retain the services of executives who might otherwise leave, by providing an opportunity to acquire an interest in the business. Encouraging the management of a business to have a proprietary interest in its successful operation will provide an important incentive to expand and improve the profit position of the companies involved.[9]

Clearly, the purpose for permitting special treatment for incentive stock options was to attract corporate management committed to, and with a vested interest in, the company's long-term success, thereby increasing the value of the stock.

1.4 Non-Qualified Stock Options

In contrast, non-statutory options (non-quals),[10] are employee options that do not meet the IRC Sec. 421(a) requirements.[11] For both ISOs and non-quals, tax consequences are triggered when the employee exercises the option. Non-quals are taxed upon exercise under IRC Sec. 83(a), which governs the receipt of property in connection with the performance of services.

Unlike a non-qual, the exercise of an ISO does not trigger an immediate tax under the regular tax system, but the spread falls within the AMT regime.[12] The AMT ignores the special provisions relating to ISOs under IRC Sec. 421(a) and treats them as non-quals under IRC Sec. 83(a), but applies AMT rates.

1.5 Section 83(b)

When Jeff received his stock options, he could not take advantage of Section 83(b) – the first tax code provision that could have eliminated his ultimate tax plight. When property (including stock) is received in connection with the performance of services, Section 83(b) permits an election to be taxed on the fair market value thereof when the property is received, without, in general, taking into consideration any substantial restrictions on the property (such as vesting). Jeff would have been taxed immediately on the spread between the option price

---

must expire no later than 3 months after the termination of employment. In some instances, there could be a long-term capital loss associated with ISOs.

[9] S. Rep. No 144, 97th Cong. 2d Sess.

[10] Non-statutory options are often called non-qualified options or "non-quals."

[11] Non-statutory employee options are taxed under IRC Sec. 83, which deals with the receipt of property for services. Generally, non-quals are taxed as compensation at the time they are exercised, provided the stock received is vested (i.e. not subject to a substantial risk of forfeiture).

[12] For example, if an employee exercises an option to purchase 10,000 shares by paying an option price of $1/share when the fair market value of the underlying stock is $50/share, for AMT purposes, there is income of $490,000 (spread per share is $50-$1 = $49; $49 x10,000 shares = $490,000).

and the fair market value of the stock received.[13] Unfortunately, Sec 83(b) does not usually apply to stock options.

1.6 Early Exercise and the Sec. 83(b) Election

Jeff could have used Section 83(b) if his company, Granite, had an "early exercise" program.[14] Jeff would have exercised his options immediately and Granite would have retained the right to repurchase the stock if he failed to meet the vesting provisions. Because Jeff would own the stock, he would be eligible to make an IRC Sec. 83(b) election.

Unfortunately for Jeff, Granite did not offer an early exercise program. Granite was an S corporation, rather than a traditional C corporation, and although there is nothing preventing an S corporation from offering an early exercise program, there could have been accounting complexities unique to S corporations if Jeff became a shareholder and later forfeited stock under the original stock purchase agreement.[15] Unfortunately, Granite's corporate status prevented Jeff from using Sec. 83(b) to lock in the spread for AMT purposes when that spread was smallest.

1.7 Managing the "Spread" on Employee Stock Options

The most critical factor determining the tax consequences of both ISOs and non-quals is the size of the spread at exercise. The greater the spread, the larger the tax.[16]

Taxing the spread at the time of exercise, rather than when the stock is actually sold or otherwise disposed of[17] is a significant departure from traditional tax rules. It is this deviation from established tax principles that has caused the catastrophe to many workers in the high-tech industry.

---

[13] As discussed in the text accompanying footnote #16, if Jeff's spread was $0.05/share and he exercised 80,000 options, his taxable income would be $4,000. More importantly, just $4,000 (the spread on his ISO stock) would have been subject to the AMT.

[14] Early exercise allows the employee to exercise his options immediately, while the vesting schedule remains in place. Instead of earning stock over time, the employee owns 100% of the stock immediately, but the company is given the right to repurchase the stock according to the vesting schedule (which now becomes a repurchase schedule). Typically, the company insists that the stock be held in escrow during the time the company has repurchase rights. Functionally, owning an employee stock option subject to vesting is the same as owning all the stock immediately, subject to the company's right to repurchase; however, under the early exercise approach, the employee elect IRC Sec. 83(b) to lock-in a small spread and usually eliminate the AMT.

[15] Because an S corporation is a "flow-through" entity, gains and losses are usually reported by shareholders on their individual tax returns, rather than reported by the corporation. Under an early exercise program, Jeff would have been entitled to his pro-rata share of the S corporation's income and loss immediately, even though the company intended that his ownership rights accrue over a 4-year vesting period.

[16] For example, assume Jeff has an option to purchase 80,000 shares at $0.05/share. If he exercises all his options when the stock's fair market value is $1, the spread is $0.95/share and Jeff will have $76,000 ($80,000 less exercise price of $4,000 = $76,000) of ordinary income for non-quals and the same amount as under the AMT for ISOs. In contrast, if Jeff could have elected immediate taxation under IRC Sec. 83(b), his income would have been limited to $4,000, the fair market value of the stock, (assume, $0.10/share) less the option price of $0.05/share ($8,000 less $4,000 option price = $4,000). His tax liability on any stock appreciation above $1/share occurs when the stock is sold.

[17] The taxation event occurs when stock is sold, exchange, abandoned, becomes worthless or otherwise disposed of in a taxable transaction.

With non-quals, the spread is immediately taxed as compensation; with ISO's the spread is taxed the same as non-quals, but under AMT rules. In either case, taxing the spread at the time of exercise, without allowing an alternative valuation mechanism when the spread subsequently collapses (and the asset is worth a fraction of the exercise value), is contrary to our system of taxation. More importantly, it creates a tax wholly disproportionate to the actual value of the asset upon sale.

1.8 Stock Options Require Investment Sophistication

There is widespread confusion among employees who own stock options. An article appearing in SiliconValley.com[18] referred to an OppenheimerFund survey which found that:

> 75 percent of the stock-option holders weren't familiar with the Alternative Minimum Tax, and that 52 percent knew "little" or "nothing at all" about the tax implications of exercising options. More than one in three couldn't say whether they held incentive stock options or the more common non-qualified options.

Employee stock options blur the distinction between workers and investors. Employees working for a paycheck do not instantly become experienced, sophisticated short-term investors just because they exercise their company's stock options. They should not be ruined financially because they failed to immediately sell those options, especially when few of the so-called market experts had any indication of the impending NASDAQ collapse. The financial decision to sell stock is often a complicated one and novice investors invariably rely on these experts.

Certainly every stockholder should be subject to identical investment risk of loss if a stock drops and should determine their taxes based on the value of the stock when sold. The tax law should not punish employees just because they did not comprehend the AMT consequences when they exercised their options, especially when the stock's value, in hindsight, was greatly inflated. Employees should be taxed when they sell their stock, just like every other investor.

If Granite offered its stock directly to outside investors, rather than to Jeff through an ISO, those eligible to purchase it would have to meet "accredited" investor requirements[19] imposed by the SEC, because the investment would be deemed risky. Yet companies are permitted to offer employee stock options, often in lieu of regular compensation[20], without adequate disclosure or access to the financial and tax expertise necessary to deal with such investments.

[18] The article was titled, Tax Disaster blindsides some who exercised stock options

[19] Generally, an accredited investor is an individual (including his spouse) with a net worth exceeding $1 million or the individual must earn more than $200,000 ($300,000 if married) per year.

[20] Start-up companies frequently offer employees lower salaries in exchange for stock options to reduce their payrolls. In these instances, stock options are used to shrink overhead, rather than as an incentive for top management to make the company profitable.

1.9 The ISO AMT Tax Trap

There are two advantages to ISOs when compared to non-quals: (1) LTCG - if the employee meets the ISO holding periods, any profit on the stock will be taxed as long-term capital gains and (2) Deferral of Tax - the employee does not have to pay ordinary income tax at the time of exercise;[21] instead, the employee is taxed under the regular tax system when the stock is sold, which could be years later.

However, these advantages can be dwarfed by the imposition of the AMT rate, often as high as 28%[22], which is eight percentage points higher than the LTCG tax rate of 20% and is 11.6 percentage points lower than the highest ordinary income tax rate of 39.6 %[23].

1.9.1 The LTCG Benefit

ISOs are treated as non-quals for AMT purposes, which means, in general, they are taxed under IRC Sec. 83(a) on the spread at the time of exercise[24], but at AMT rates rather than ordinary income rates. While the exercise of a non-qual is treated as compensation that requires withholding taxes upon receipt of that stock, no such withholding requirement for the AMT is imposed on ISOs. If the employee continues to hold his company's stock after exercising an ISO, he is gambling with tax dollars owed to Uncle Sam, whether he realizes it or not. Jeff triggered a punishing tax event, because exercising an ISO is a tax item under AMT rules and the spread is income.[25]

1.9.2 The Deferral Benefit

There is no longer a benefit associated with deferring taxes to a future year, because an employee is required to pay AMT in the year of exercise. For example, assume a taxpayer exercises ISOs with a spread of $1,000,000 and assume the AMT totals $280,000. Even if the taxpayer sells the stock 3 years later for the same price per share (i.e. $1,000,000 profit), his federal LTCG tax will be $200,000. Thus, there is no economic advantage to deferring income taxes.[26]

Moreover, the taxpayer paid $280,000 in AMT but only $200,000 will offset the LTCG tax when the stock is sold. The $80,000 balance is considered an AMT credit under IRC Sec.

---

[21] IRC Sec. 421(a)(1).

[22] The AMT has two tax rates, 26% for the first $175,000 of Alternative Minimum Taxable Income, determined after exemptions and, in general, 28% on the excess.

[23] The pending tax reform legislation may reduce the highest tax rate to 33% which means the difference between ordinary income tax rates and the AMT will be 5 percentage points.

[24] The ISO spread is taxed under IRC Sec. 83(a). In general, the stock's fair market value is determined at the time the stock is received. If the stock is not freely transferable or is subject to a substantial risk of forfeiture, the fair market value is determined when either of these conditions no longer exist.

[25] For example, if the FMV of the stock was $80/share and the exercise price was $5/share, the spread would be $75/share. If Jeff exercised 100,000 options, his spread would be $7.5 million. Under the AMT, this $7.5 million could be taxed as high as 28%, thus, Jeff would immediately be liable for $2,100,000 in federal taxes under the AMT, payable by April 15th of the following year.

[26] If AMT is eliminated for ISO's there could be a tax benefit for deferral. This could be easily remedied by charging interest on the taxes that have been deferred.

53 that may be used in subsequent years, but unless there is a large capital gain in future years, it could take several generations to exhaust the AMT credit.[27]

1.10 AMT and Disqualified Dispositions

Prior to the elimination of qualified options in 1976, the spread was considered a tax preference item under then-existing minimum tax provisions. When ISOs became part of the law in 1981, initially they were not subject to the AMT. That changed the following year, when Congress enacted the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA). The Congressional history of TEFRA made it clear that the AMT should only apply when the employee was eligible for capital gains treatment. If the employee made a disqualified disposition, the AMT would not be imposed:

> In addition….a preference is added for the excess of the fair market value of stock received upon the exercise of an incentive stock option over the exercise price. It is intended that the <u>incentive stock option preference not apply</u> where there is an early disposition of the stock acquired through the exercise of the option. [28] [emphasis added]

The General Explanation of TEFRA, page 19, confirms that the AMT does not apply if the special capital gains treatment provided an ISO is denied because of an early disposition:

> Furthermore, a preference is added for the excess of the fair market value of stock received upon the exercise of an incentive stock option over the exercise price. <u>It was not intended that the incentive stock option preference apply, however, where the special tax treatment for incentive stock options does not apply because there is an early disposition</u>, as specified in section 422A(a)(1), of the stock acquired through the exercise of the option. [emphasis added]

According to the legislative history, a disqualifying disposition, even if it occurs after the year in which the ISO is exercised, should have removed the spread from the AMT.[29]

Despite the clear intention of Congress that AMT not apply to early dispositions of ISO stock, Congress changed the AMT treatment of ISOs in 1986 and in the process, passed IRC Sec. 56 (b)(3) which provided that the AMT is eliminated only if a disqualifying disposition

[27] In many cases, the AMT credit will never be used. The AMT credit applies in future tax years only when, in any given year, the regular tax exceeds the AMT, and then only to the extent of the difference. Because the AMT is not currently adjusted for inflation, it will become the primary tax for millions of taxpayers. Therefore, as a practical matter, the AMT credit may never be used, unless the taxpayer has a large capital gain in the future.

[28] <u>H.R. No 97-760</u>, page 475.

[29] For example, if a taxpayer exercised an ISO, the company transferred the stock on March 30, 2000, and the taxpayer sold the stock on March 29, 2001, a disqualified disposition would have occurred since the taxpayer did not hold the stock for one year. Assume the spread was $75/share on the date of exercise (the value used for the AMT) and $5 only on the date of disposition, the taxpayer should pay ordinary income tax on the $5/share spread rather than AMT on the $75/share spread. Assuming maximum tax rates apply, the taxpayer will pay 39.6% federal on $5/share spread ($1.98/share tax) compared to 28% federal on $75/share spread ($21/share tax). If the sale involved 100,000 shares, the resulting tax would be $198,000 under the early disposition rules, rather than $2.1 million under the AMT regime.

occurs in the same tax year in which an ISO is exercised. The taxpayer in the example contained in footnote #28 would owe $21/share of AMT despite an early disposition of his stock because the disposition occurred in a later year.

Under IRC Sec. 56(b)(3), taxpayers who failed to sell their stock by the end of 2000 were automatically subject to AMT based on the spread at exercise, even though their stock dropped dramatically during the first quarter of 2001. Had the original congressional intent been enacted into law, taxpayers could have bailed out of the AMT trap by selling stock within 12 months; thus if a taxpayer exercised an ISO and the corporation transferred the stock on March 30, 2000[30] his deadline to avoid the AMT would have been March 29, 2001, instead of December 31, 2000.

1.11 The Disqualified Disposition Tax Trap

Workers who believed in their companies and wanted to maintain their investment, yet avoid the imposition of the AMT on a non-existent spread may have thought they could just immediately repurchase their stock after sale. Others may have reasoned they could gift the stock or sell it to a family member to avoid the AMT. Wrong!

A little-noticed provision in the tax code permits a disqualified disposition to be taxed without AMT consequences only if the loss from the disposition, "if sustained, would be recognized."[31] This means the stock must be disposed of in a transaction in which the taxpayer would have recognized the loss on his tax return. Unfortunately, there are several tax code provisions that prevent a loss from being recognized.

If an employee repurchases stock in his company within 30 days prior to or after the disposition, then the wash sales rules of IRC Sec. 1091(a) deny the loss.[32] Also, there is no loss recognized with a gift transfer, or a sale to a related party under IRC Sec. 267 (a)(1). Prop. Reg. 1.422A-1 (b) (2) contains an example where a disqualified disposition sale to a family member in the same year of exercise did not prevent the AMT because the loss would not have been recognized under IRS Sec. 267.

Apparently, it seems that few were aware of this rule. Apparently, brokers who told their clients to sell by the end of the year to avoid AMT and to reacquire the stock, quickly asserted that they were not tax advisors and the client was responsible for the tax consequences of their investments. One commentator made the following observation concerning this bad tax advice:

> What is more remarkable is that a rule of so great importance to so many people is so little known. During November 2000, both the Wall St. Journal (in a front

[30] Under IRC Regs. §1.421-7(g), the holding period begins when the corporation transfers of ownership of such share to the employee (or the transfers of substantially all the rights of ownership). The transfer it must be recorded in the corporate records within a reasonable time after it occurs.

[31] IRC Sec 422(c)(2) involves the elimination of AMT if the year of exercise and disposition are the same, provided that "such disposition is a sale or exchange with respect to which a loss (if sustained) would be recognized to such individual."

[32] In general, IRC 1091(a) applies to the sale and acquisition of "substantially identical" stock or securities, which clearly includes common stock sold and repurchased in the same company.

page tax column) and Business Week magazine described the need to sell depreciated ISO stock before the end of the year and told their readers they could purchase replacement shares if they wanted. There is reason to believe a large number of option holders are receiving similar advice from financial advisors who are unaware of this rule. [33]

1.12 Lack of Information Regarding the Disqualified Disposition Tax Trap

In Tax Management Portfolio (TMP), Portfolio 381-2nd, entitled Statutory Stock Options, considered a leading source of tax information by attorneys and accountants, this issue is not discussed either. TMP amended the portfolio in May 2001 and the updated version now discusses this trap. There is no mention of the problem in the CCH Standard Federal Tax Reporter explanations either, although one finds the proposed regulation within the tax service. IRS Publication 525 (dealing with employee stock options) discusses ISOs, but fails to mention the interplay between a disqualified disposition and the wash sales rules.[34]

According to Michael Gray[35], TurboTax, a leading tax software package evidently used by millions to prepare and file their income taxes, did not include this rule as part of its tax interview process. Thus, in situations where the loss would not be recognized, those preparing their own taxes with this software would have improperly claimed disqualified disposition treatment on the sale of their stock.[36]

As a nation, we have developed a tax system with rules so obscure that even leading financial and business magazines, newspapers, tax experts and major tax publications are unaware of and cannot provide accurate information to taxpayers, until the problem comes to light after many have fallen into the trap.

1.13 Taxing Net Worth Rather Than Realization Upon Sale

Both ISO and non-quals are taxed on the spread upon exercise, an accrual concept of taxing wealth on a specific valuation date. In addition, the stock is taxed again under the traditional "realization" concept when it is sold. In discussing the appropriate time to extract a tax, Bittker and Lokken, Federal Income Taxation of Income, Estates and Gifts, second edition (Bittker and Lokken), stated:

---

[33] Kaye Thomas, Dangerous Advice? Sale and Repurchase of ISO Stock in a Disqualifying Disposition, www.fairmark.com.

[34] IRS's audit manual for its agents, under its Market Segment Specialization Program, Alterative Minimum Tax for Individuals, TPDS No. 84294S (12-1999), failed to mention this rule as well. Therefore, IRS auditors conducting an examination would be unaware that the AMT continues to apply if the taxpayer disposes of ISO stock in the year of exercise, when the loss from the disposition is not recognized

[35] Mr. Gray is co-author of Employee Stock Options – A Strategic Planning Guide for the 21st Century Optionaire.

[36] Michael Gray, ESOAA. In Option Alert #6 entitled, "An irregular alert for issues relating to employee stock options," February 6, 2001 (www.stockoptionadvisors.com). Mr. Gray noted that TurboTax recently added the general disqualified disposition rule in an update, but failed to mention the wash sales rule relating to the early disposition of ISO shares. Also, he claims that TurboTax did not inquire about minimum tax credit carryover information from previous years and that AMT basis adjustments did not properly carryover from the federal return to the California return. Apparently, tax software programs cannot accurately calculate the AMT.

> The Haig-Simons definition of income calls for periodic valuations of the taxpayer's assets and liabilities so that increases and decreases in net worth can be taken into account as they accrue. With minor exceptions, however, gains and losses are taken under present law only when realized by sale, exchange, abandonment, or other disposition. The realization approach defers tax on accrued but unrealized gains and losses.

Taxing an asset based on accrued wealth, rather than realized gain or loss, as Bittker and Lokken observed:

> would require taxpayers to pay tax on gains that have not been reduced to cash; taxpayers whose unrealized gains are high in relation to their money incomes would face a cash squeeze, particularly if the unrealized gains were in assets that were difficult to sell or could not be sold without disrupting the taxpayer's business.

The current system determines the tax on realization, rather than accrual of phantom gains, because the actual gain or loss can be accurately measured only when the asset is sold and has been reduced to cash. Also, taxes can be paid from the proceeds.

Stock options, however, are taxed when the stock is received and the wealth accrues. This can cause a tax calamity if the stock is not immediately sold and subsequently plunges in price. Ironically, the incentive for employees to retain stock in their corporations for the long term is obliterated by a tax law that requires the employee to sell immediately or face potential financial disaster should the stock price drop dramatically. Using an accrual approach to tax employee stock options is inappropriate because of the stock's potential instability.

1.14 The Exercise-of-Option — Sale-of-Stock Tax Continuum.

IRC Sec. 83(a) taxes property received through the performance of services. Theoretically, there should be no difference between receiving $1,000 cash and an asset worth $1,000 as compensation; both should be taxed identically. The problem arises when the asset's value is extremely volatile and can be worth 10x or 1/10x its original value within weeks. IRC Sec. 83(a) concept of taxing property at its fair market value on date of receipt can cause serious dislocations if the value abruptly increases or decreases.

Taxing an asset as to its fair market value on the date of receipt, rather than when it is sold, assumes the asset can be sold freely and without adverse consequences. Often, employee stock cannot be sold immediately. There may be restraints on the stock under securities laws or by underwriters and investors. Also, the company may have policies and restrictions regarding employee stock sales.

Even if the stock could be sold immediately, the accrual concept places a premium on becoming a successful speculator and severely punishes those who hold their stock because they believe in the long-term goals of their company, the original intent of ISOs, if the stock's value deteriorates.

1.15 Does the AMT Violate the Fifth Amendment?

Although the Fifth Amendment is not a direct limit on Congress's taxing authority, there could be a violation of the Fifth Amendment if the tax is so high, it amounts to a confiscation of property. Brushaber v Union Pac. RR.[37] The Court noted that the due process clause could apply:

> [If] the act complained of was so arbitrary as to constrain to the conclusion that it was not the exertion of taxation but a confiscation of property, that is, a taking of the same in violation of the Fifth Amendment, or, what is the equivalent thereto, was so wanting in basis for classification as to produce such a gross and patent inequality as to inevitably lead to the same conclusion.

With respect to the limitation of Congressional taxing authority, one early commentator noted:

> [There] is no more incongruity in having the federal taxing power limited by the Fifth amendment than in having state taxing power limited by the Fourteenth Amendment. The existence of power on the one hand and the constitutional restrictions on its exercise on the other is of the essence of our constitutional system. To borrow the simile of [a prior author], a train is not self-destructive because it has both motive power and brakes.[38]

Many taxpayers are facing an AMT that exceeds the value of their stock by several times; indeed for some, the AMT surpasses the value of their entire net worth by an astonishing six or seven figures. The AMT, in these situations, clearly amounts to confiscation of property and, because of the severity of the tax, could violate the due process clause of the Fifth Amendment.

In addition, the argument could be made that the sheer complexity of the AMT violates the due process clause because a large segment of average taxpayers cannot understand it. At some point, a law can be so complex and incomprehensible to those who must abide by it that the law could violate the Fifth Amendment's due process clause.

Whether or not the extreme application of the AMT approaches a constitutional violation of due process, it is fair to say that as applied to stock options, the AMT can cause financial ruin and is manifestly unfair and inequitable to those who stumble into its trap.

[37] 240 U.S. 1 (1916).

[38] Bittker and Lokken, page 1-28, quoting from Powell, Constitutional Aspects of Federal Income Taxation, in the Federal Income Tax 89 (Haig, ed.; Columbia U. Press 1921).