

AMT Meets ISO – Thousands of High-Tech Employees are Devastated

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1.1 Introduction

When Enron's stock collapsed, many employees who invested their 401(k) retirement funds in company stock lost it all. Now imagine if those Enron employees discovered that not only did they lose their retirement, they now must pay taxes based on the value of their Enron stock before its crash!

Welcome to the nightmare that has befallen thousands of employees in the high-tech economy who also believed in the long-term prospects of their companies and, as part of their compensation, received incentive stock options (ISOs).¹ Similar to Enron employees, many of these workers were victimized by alleged stock manipulation by their company executives and investment bankers², and like Enron, many of these companies are now in bankruptcy. In fact, the number of securities-related class-action lawsuits filed in 2001 more than doubled the next highest year.³ However, unlike the Enron debacle, the ISO disaster was compounded by a tax-code malfunction involving the Alternative Minimum Tax (AMT).

¹ Unlike a 401(k) plan where employees received full salaries in addition to retirement benefits, receipt of ISOs was often an integral part of the employee's compensation package, replacing a substantial portion of wages and salaries. .

² For example, see the \$100 million settlement and future injunction between the SEC and Credit Suisse First Boston, a New-York based brokerage firm and investment bank, relating to alleged kickbacks in the sale of IPO stock in several prominent high-tech offerings. SEC Litigation Release 17327- 1/2/02.

³ According to the March, 2002 American Bar Association Journal, 487 consolidated federal security class-action lawsuits were filed in 2001; the previous high was 236, filed in 1998.

The result: Taxpayers who were encouraged by Congress to hold their company's stock for the long-term, instead saw that stock dwindle to a small fraction of its value at the time of exercise. Even though they sold nothing and did not obtain any real economic value for their investment, these employees are being taxed under the AMT on the higher value when they exercised their ISOs.

1.2 Background – Conflicting Tax Code Provisions

The ISO/AMT problem was caused by conflicting code provisions, which have produced an unforeseen and inequitable tax liability. Specifically, it involved the interplay among three code sections:

a. IRC Sec. 422 permits companies to issue incentive stock options to employees, giving those employees a long-term financial incentive tied to the company's growth and prosperity. Employees are not taxed when they exercise their stock options and if they meet the IRC Sec. 422 holding requirements, they will qualify for the lower long-term capital gain rate (maximum 20% federal) instead of paying the higher ordinary income tax rate (maximum 39.6% federal in 2000).

b. IRC Sec. 83 states, in general, that property (in their case, stock) received as compensation for services must be valued at the fair market value on the date of receipt, without regard to restrictions, unless those restrictions are permanent. The upshot of Sec. 83 is that taxpayers exercising ISOs must claim the fair market value on the date of exercise, even if those taxpayers are legally prevented from selling the stock for an extended period .

IRC Sec. 83 may greatly overvalue the stock by rejecting the commonplace definition of fair market value, which would take into consideration the fact that stock is extremely volatile and restrictions preventing sale would greatly reduce the actual FMV.

c. IRC Sec. 56(a)(3) states that the spread between a stock's FMV and its exercise price is a tax preference for AMT purposes. Thus, the AMT, originally enacted

to ensure that the very wealthiest taxpayers--who at that time were escaping the payment of any tax -- would be required to pay at least a minimum tax, now applies to middle-class workers who receive no tangible economic benefit from the exercise of their ISOs. Because the AMT has not been adjusted for inflation it is hitting the wrong group of taxpayers (i.e. middle-class employees).

Congress intended the AMT liability arising from the exercise of ISOs to be a timing issue: The taxpayer would receive an AMT credit when stock was subsequently sold, which would, in theory, offset the original AMT. Thus taxpayers were merely prepaying their tax liability through the AMT and would recover the prepayment when the stock was sold. However, because of design flaws in the AMT credit, taxpayers are not permitted to use the AMT credit to offset the existing AMT liability when the stock is subsequently sold for a fraction of the outstanding AMT liability.⁴

Example: In January, an employee receives a grant of 10,000 ISOs exercisable at \$.001/share. Later in March, when the stock is valued by the company at \$100/share the employee exercises his ISOs. Under IRC Sec. 83, the employee must compute his tax using the \$100/share valuation regardless of the stock's actual worth.⁵ Thus, the employee has a \$1 million "tax preference" under the AMT⁶ and a potential federal AMT liability of \$280,000 (assuming the maximum 28% AMT tax rate)⁷.

⁴ The credit must be carried forward and used only when the regular tax liability exceeds the AMT liability for any given year, and only to the extent of the difference. For example, if in a future year the regular tax liability is \$50,000 and the AMT is \$40,000, then the \$10,000 balance of the AMT credit may be used to reduce the regular tax liability to \$40,000.

⁵ The actual fair market value is irrelevant – the taxpayer cannot take into account any restrictions (such as company imposed blackout periods, SEC insider information rules or company repurchase rights) unless those restrictions are permanent.

⁶ The spread is the difference between the fair market value of the underlying stock at the time of exercise and the option price paid. The AMT tax preference is based on the spread between the stock's value on the date of exercise, minus the exercise price. In this example, the exercise price is negligible, so the stock's value is equal to the spread.

⁷ The taxpayer could be liable for state AMT as well. For instance, in California, the AMT rate is 6%.

The employee, encouraged by Sec. 422 to hold the stock long-term to obtain the favorable capital gains treatment, does not sell the stock by the end of the year. In January the following year, the stock crashes to \$5/share. The result: The taxpayer owes a federal \$280,000 AMT, on stock now worth only \$50,000 (10,000 shares X \$5/share). Even if the employee sold all the stock and applied the entire \$50,000 in proceeds to the AMT liability, he would still owe \$230,000 in federal taxes.

Although the employee has an AMT credit under IRC 56(a)(3) that could potentially eliminate the remaining \$230,000 owed, the credit cannot be used to offset AMT because it arose in the prior year.

[end of part 1]