September 2002 Hot Topics - Part 2 of a 2-part series

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

1.3 IRS Recognizes the AMT Problem

Nina E. Olson, in her National Taxpayer Advocate's FY2001 Annual Report to Congress dated December 31, 2001, uses this example to illustrate the problems with the AMT as it affects ISOs:

> A taxpayer accepts a job offer with a compensation package that includes incentive stock options to supplement his salary. In order not to lose his vested options, the taxpayer exercises them. The AMT is calculated on the value of the shares at the time the taxpayer exercised the options, not on the depressed share price when he actually sells them. Although the transaction may generate thousands of dollars in AMT credits, the taxpayer cannot use them against future income tax since he will not recognize significant gain from the sale of his depressed stock. (Page 171)
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> [AMT] creates taxpayer confusion and anger because it catches taxpayers unaware, often operates in a counter-intuitive fashion, and penalizes certain transactions that serve public policy goals (e.g. ....the use of incentive stock options to encourage employee engagement and investment in companies).

The result: Employees are blindsided by an AMT liability that arises when they exercise their ISOs. Congress intended employees receiving ISOs to hold their stock for the long-term and help grow and prosper the company. However, complying with the clear Congressional intent proved disastrous when stock prices subsequently plunged in value, because taxpayers were required to report the spread for AMT purposes at the time the stock was exercised.

In addition, if the taxpayer eventually sells the stock for less than the AMT liability amount, he is prevented from using the AMT credit remaining after the stock is sold to offset the existing AMT liability, even though both arose from the same transaction and Congress intended that an offset would occur.

1.4 Ruining the Lives of Thousands of Taxpayers

Reformamt.org, formed in response to the ISO/AMT issue, has approximately 1,600 members who owe on average $300,000 in AMT liability. Nationwide, the number of taxpayers facing this problem is estimated to be 10 to 20 times that, or 15,000 to 30,000.

What thousands of taxpayers in our country have experienced should not have occurred under our tax code. An AMT designed to cause the very wealthy to pay a minimum amount of tax as they earn their fortunes, should not boomerang and clobber middle-class families earning part of their compensation (wages and salaries) in the form of ISOs. There is no public policy or any economic justification for taxing these workers often more than 100% of the actual value of their stock. Indeed, for many victims, the tax greatly exceeds their entire net worth.

1.5 The Alternative Valuation Approach

Congress has recognized the absurdity of requiring taxpayers to be taxed based on the "phantom value" of an asset and in 2001, introduced legislation specifically targeting this situation with retroactive tax relief[1]. Under proposed legislation, taxpayers who exercised ISOs in 2000 will have the choice of using the stock valuation on April 15, 2001, instead of the values on the date(s) of actual exercise, for purposes of determining their tax preference under IRC Sec. 56(b)(3).

This legislation uses the alternative valuation date approach found in the estate tax area. IRC Sec. 2032(a) allows an executor to elect to value assets six months after death if this will result in a lower overall estate assessment. IRC Sec. 2032(a) recognizes that it is unfair to tax an estate based on the date of death if the value plunges within six months thereafter. Ironically, it was another devastating stock market collapse (the 1929 crash) that prompted this alternative approach to valuing estates.

[1] HR 2794 and S 1324.

1.6 Using the AMT Credit

Another way to resolve the ISO/AMT problem is to free up AMT credits once the stock that caused the AMT is sold. If those credits could be applied against the AMT liability, taxpayers could match the tax with the credit, as Congress originally intended. Rather than retroactive legislation, this approach is modeled after the net-operating-loss carryback rules that currently exist in the code.

If Congress does not enact legislation to remedy the problem, it still can direct IRS to use its considerable equitable powers under the "effective tax administration" rules[2], to use AMT credits as an offset to AMT liabilities. This solution could provide relief to taxpayers who have been devastated by the AMT, without causing a politically sensitive vote on AMT legislation.

1.7 Voluntary Reporting of ISO Exercise

The exercise of ISOs is not a reportable event under current law. Individual taxpayers must voluntarily disclose AMT liability arising from the exercise of ISOs. Future voluntary compliance could become a major issue for IRS if the result of strict enforcement drives law-abiding, taxpaying, middle-class workers into the underground economy and off the IRS radar screen. Taxpayers would have little moral incentive to voluntarily comply with a tax law that unfairly destroys their financial worth and severely restricts their earnings for the foreseeable future.

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[2] Reg. §301.7122-1T(b)(4). Offers-in-compromise may now be based on factors such as equity, hardship and public policy where compromise would promote effective tax administration.

IRC Reg. §301.7122-1T(b)(4) provides that an offer-in-compromise is acceptable to promote effective tax administration when exceptional circumstances exist such that collection of the full liability will be detrimental to voluntary compliance by taxpayers, and compromise of the liability will not undermine compliance by the taxpayer with tax laws.

1.8 Conclusion

The AMT wrecking ball has smashed through our high-tech sectors with its indiscriminate application to ISOs, causing wide-spread devastation to those who exercised their options in good faith, while watching their stock collapse as they worked for the long-term prospects of their companies. This was not how either the AMT or ISOs were supposed to work.

Imposing an AMT upon exercise of an ISO without providing statutory mechanisms to revalue the stock if it subsequently plummets, places workers at risk, because while their financial worth evaporates, they remain liable for tax on income never realized. What type of economic system would purposely do this to its nation's workers?