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COMMENT REGARDING SPECIFIC PROPOSAL TO REFORM THE
ALTERNATIVE MINIMUM TAX

President's Advisory Panel on Federal Tax Reform
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SUMMARY

After the Internal Revenue Service modified the Instructions to Form 6251 without Congressional authorization, taxpayers have been subject to a potential 70 percent tax bracket on economic income due to the effect on the changes in the instructions on the Alternative Minimum Tax (AMT) and the AMT Credit. We would recommend that Congress review and ratify the position argued in Petitioners Motion for Partial Summary Judgment in the United States Tax Court Case of *Robert J. Merlo v. Commissioner of Internal Revenue*, Case No. 21538-03, which is presently being argued before the Court. This argument is adopted from the text in the treatise ROOK AND PAULUKONIS, "TAX PLANNING FOR THE ALTERNATIVE MINIMUM TAX," Lexis Nexis Matthew Bender 2003, § 6.04[2], pgs. 6-21 to 6-23, note 105. The Petitioners have requested that the Tax Court rule on this unresolved issue which has been raised by prominent members of the American Bar Association Tax Section.

DESCRIPTION OF PROPOSAL

(1) Congress should enact legislation that under I.R.C. § 56(d)(2)(A)(i) the AMT negative adjustment described in the instructions to Form 6251 (hereinafter, "negative adjustment") resulting from the sale of stock exercised under an Incentive Stock Option Plan at an AMT loss is not limited to section 1211 restrictions when the taxpayer has a regular tax gain and an AMT loss.

(2) Congress should enact legislation that under I.R.C. § 172(c) a taxpayer is required to carryback their AMT negative adjustment described in the instructions to Form 6251 under I.R.C. § 56(d) absent an election to carry the losses forward under I.R.C. § 172(b)(3)(C) which result from (a) the amount of ordinary income from an ISO disqualifying disposition under I.R.C. § 422(c), (b) any capital gain or loss from the sale of the stock, or (c) the amount of the AMT loss from the sale of the stock.

(3) Congress should enact legislation that under principles of equity, taxpayers are entitled to relief from the mandatory 5 year carryback requirement for AMT NOLs incurred in 2001 and 2002 under I.R.C. § 172(b)(1)(h) when the taxpayer failed to make an election to carry their losses back two years or carry their losses forward because of the uncertainty caused by the change in the Instructions to Form 6251 in 2001.

IMPACT OF PROPOSAL RELATIVE TO CURRENT SYSTEM

The position being argued before the Tax Court is fair, simple, and transparent. It is consistent with the IRS instructions to Form 6251 for the years 1988 to 2000. Commentators in the tax community have expressed concern that the instructions to Form 6251 were changed in 2001 without authorization from

Congress to limit AMT losses to \$3,000. This has the effect of disallowing AMT losses and the use of the AMT Credit.

TRANSITION, TRADEOFFS AND SPECIAL ISSUES

The proposals should be given retroactive effect because the IRS has changed the instructions to Form 6251.

1. Overview

Section 55 of the Internal Revenue Code, as amended by the Tax Reform Act of 1986 (the Act), § 701(a), 1986-3 (Vol. 1) C.B. 237, imposes a tax equal to the excess, if any, of the tentative minimum tax for a taxable year over the regular tax for that year. The tentative minimum tax for a taxable year is based, in part, on AMT income. AMT income means the taxpayer's taxable income adjusted pursuant to I.R.C. §§ 56, 57 and 58.

The Internal Revenue Code mandates a positive AMT adjustment at the time of exercise of ISOs as defined in § 422.¹ I.R.C. § 56(b)(3) (AMT treatment of incentive stock options) states:

Section 421 shall not apply to the transfer of stock acquired pursuant to the exercise of an ISO (as defined in § 422). Section 422(c)(2) shall apply in any case where the disposition and the inclusion for purposes of this part are within the same taxable year and such section shall not apply in any other case. The adjusted basis of any stock so acquired shall be determined on the basis of the treatment prescribed by this paragraph.

¹ I.R.C. § 56(a) Adjustments in AMT income states:

Adjustments applicable to all taxpayers. In determining the amount of the AMT income for any taxable year the following treatment shall apply (in lieu of the treatment applicable for purposes of computing the regular tax)

The Internal Revenue Code mandates a negative AMT adjustment at the time of sale of the underlying stock. I.R.C. § 56(a)(4) Alternative Tax Net Operating Loss

Deduction states:

The alternative tax NOL deduction shall be allowed in lieu of the net operating loss deduction allowed under § 172.

I.R.C. § 56(d) Alternative Tax NOL Deduction Defined states:

(1) For purposes of § 56(a)(4), the term "alternative tax NOL deduction" means the NOL deduction allowable for the taxable year under § 172, except that

(A) the amount of such deduction shall not exceed 90 percent of AMT income determined without regard to such deduction, and

(B) in determining the amount of such deduction

(i) the NOL (within the meaning of § 172(c)) for any loss year shall be adjusted as provided in paragraph (2), and

(ii) appropriate adjustments in the application of § 172(b)(2) shall be made to take into account the limitation of subparagraph A.

(2) Adjustments to NOL computation.

(A) Post - 1986 Loss Years. In the case of a loss year beginning after December 31, 1986, the NOL for such year under § 172(c) shall

(i) be determined with the adjustments provided in this section and § 58

(ii) be reduced by the items of tax preference determined under § 57 for such year.

An item of tax preference shall be taken into account under clause (ii) only to the extent such item increased the amount of the NOL for the taxable year under § 172(c).

A taxpayer is entitled to carryback an AMT NOL under I.R.C. §§ 56(d) and

56(d)(2)(B)(i).

2. AMT Tax Treatment for the Exercise of ISOs and the Sale of the Shares

The legislative history mandates a positive AMT adjustment at the time of exercise of an ISO under I.R.C. § 56(b)(3) and a negative AMT adjustment at the time of the sale of the underlying stock under I.R.C. § 56(d). A Senate Report from the 100TH Congress stated that:

[T]he bill provides that for purposes of the individual minimum tax, stock acquired pursuant to the exercise of an ISO exercised after October 16, 1987, will be treated without regard to the rules of § 421. Instead the rules of § 83 will apply to the stock in determining the individual's AMT income. For example, if a taxpayer acquires stock pursuant to the exercise of an ISO and disposes of the stock in the same taxable year, the tax treatment under the regular tax and the minimum tax will be the same; if the stock is disposed of in a disqualifying disposition in a subsequent taxable year, the "spread" between the option price and fair market value of the stock (determined in accordance with rules of § 83) will be included in AMT income in the first taxable year and in taxable income (but not in AMT income) in the subsequent taxable year. In addition, if the stock acquired is subject to a lapse restriction, amounts will be included in the AMT income in accordance with the rules of § 83. (For options exercised on or before October 16, 1987, and disposed of in a disqualifying disposition, the minimum tax treatment and the regular tax treatment will be the same for both the year of exercise and the year of disposition.)

S. REP NO. 100-445; 100th Cong., 2d Sess. 2238 (1988).

House Committee Report on P.L. 101-239 (Omnibus Reconciliation Act of 1989) stated:

ISOs. The bill clarifies that the minimum tax rules applicable to a disqualifying disposition of stock acquired pursuant to the exercise of an ISO where the amount realized is less than the value at the time of exercise follows the regular tax rules of § 422A(c)(2) where the stock is disposed of in the same taxable year the income is taken into account for minimum tax purposes. Thus the amount included in AMT income will not exceed the amount realized on the sale or exchange of the stock over the adjusted basis of the stock.

The Internal Revenue Service (hereinafter, IRS) has acquiesced to the negative AMT adjustment treatment in its instructions to Form 6251 for the years 1993-2000 which state:

Enter on line 9 [Form 6251] the difference between the gain or loss, if any, reported on the regular tax and that figured for the AMT. If (a) the AMT gain is less than the regular tax gain, (b) the AMT loss is more than the regular tax loss, or (c) you have an AMT loss and a regular tax gain (or no gain or loss for the regular tax), enter the difference as a negative amount.

There is no mention of the application of I.R.C. § 1211 restrictions in the 1993 to 2000 instructions to Form 6251. Under the IRS instructions to Form 6251 prior to 2001, the AMT negative adjustment at the time of sale of the stock exercised under I.R.C. § 422 always equals AMT Gain at the time of exercise. This is consistent with Congressional policy. The House Committee Report on P.L. 101-239 (Omnibus Reconciliation Act of 1989) stated, “the amount included in AMT income will not exceed the amount realized on the sale or exchange of the stock over the adjusted basis of the stock.”

I.R.C. § 56(b)(3) contemplates, by its operation, that the negative ISO adjustment has the same AMT character as the prior positive adjustment. I.R.C. § 56(b)(c) provides that the negative and positive adjustments may be netted. Netting the tax effects of two separate transactions, even within a taxable year, is only allowable where the effects have the same character. Thus, Congress must have believed that the positive and negative AMT adjustments applicable to ISO have the same character for AMT purposes.

The instructions to the Form 6251, Line 9 AMT Negative Adjustment for the years 1989 through 2000, satisfies the test for both sales of stock under which an AMT positive adjustment was reported under I.R.C. § 56(b)(3) in the same taxable year and for sales in a subsequent taxable year. This test produces a symmetrical result for tax purposes in that the AMT positive adjustment from the exercise of the ISOs always equals AMT negative adjustment from the sale of the stock always equals AMT Gain at the time of exercise. This result would also permit the taxpayer to offset an AMT

negative adjustment against an AMT positive adjustment if the taxpayer exercises ISOs in the same taxable year.

3. The IRS has arbitrarily and contrary to law sought to impose I.R.C. § 1211 restrictions on the AMT Negative Adjustment

The administrative construction embodied in the instructions to Form 6251 has been uniform from 1989 to 2000 as to the AMT positive or negative adjustment treatment of the sale of ISOs. In the meantime successive revenue acts have reenacted, without alteration. The definition of AMT positive or negative adjustment, was not altered and remained in subsequent revenue acts. Congress has not enacted legislation to impose section I.R.C. § 1211 limitations under I.R.C. §§ 56(d) or 56(d)(2)(B)(i) on the amount of taxpayers AMT negative adjustment which can be used to offset taxpayers AMT positive adjustment from the exercise of an ISO or sale of the underlying shares.

Moreover, Congress has not enacted legislation to impose I.R.C. § 1211 limitations on the definition of AMT income under I.R.C. § 55(b)(2) in the calculation of the credit for prior year minimum tax liability under I.R.C. § 53. I.R.C. § 53(c) provides that the credit allowable for any taxable year shall not exceed the excess of the regular tax liability of the taxpayer for such taxable year reduced by the sum of the credits allowable over the tentative minimum tax for the taxable year. Congress has not authorized the I.R.C. § 1211 limitation the Service has prescribed to AMT negative adjustment items.

The IRS instructions to Form 6251 prior to 2000 allow the treatment that Congress had intended with respect to allowing the taxpayer to utilize his or her AMT credits without restrictions under I.R.C. § 1211. The instructions beginning in 2001 would require a change in the statutory law in order to be effective.

The Treasury's purported authority for imposing I.R.C. § 1211 restrictions is not the result of legislative or judicial law. It is the result of a commentary from a legislative staff member contained in the General Explanation of the Tax Reform Act of 1986² (hereinafter, "TRA") in the 1986 Blue Book (hereinafter, "1986 Blue Book") which contains the following language:

STRUCTURE OF MINIMUM TAX AS AN ALTERNATIVE SYSTEM: -- For most purposes, the tax base for the new AMT is determined as though the AMT were a separate and independent income tax system. Thus, for example, where a Code provision refers to a 'loss' of the taxpayer from an activity, for purposes of the AMT the existence of a loss is determined with regard to the items that are includable and deductible for [A]MT, not regular tax, purposes.

In certain instances, the operation of the AMT as a separate and independent tax system is set forth expressly in the Code. With respect to the passive loss provision, for example, § 58 provides expressly that in applying the limitation for minimum tax purposes, all minimum tax adjustments to income and expense are made and regular tax deductions that are items of tax preference are disregarded.

In other instances, however, where no such express statement is made, Congress did not intend to imply that similar adjustments were not necessary. Thus, for example, for [A]MT purposes, it was intended that § 1211 (limiting capital losses) be computed using [A]MT basis, that § 263A (requiring the capitalization of certain depreciation deductions to inventory) apply with regard to [A]MT depreciation deductions, and that § 265 (relating to expenses of earning tax-exempt income) apply with regard only to items excludable from AMT income. [General Explanation of the 1986 Act, supra at 438; fn. Refs. Omitted and alterations made by respondent.]

See General Explanation of the Tax Reform Act of 1986, prepared by the Staff of the Joint Committee on Taxation, 99th Cong., 2d Sess., pages 429-473 (Minimum Tax Provisions)(May 4, 1987); P.L. 99-514. The language quoted from the 1986 Blue Book does not otherwise appear in the legislative history of TRA 1986. Thus, it might be

² The General Explanation is unofficial because it is prepared after the legislation is enacted, and Congress does not vote on its language. Before "new" language (not part of the official committee reports) can appear in the General Explanation, staff of the House, Senate and Treasury must all agree the language reflects congressional intent at the time the law was enacted.

argued that this language reflects the view of the Staff of the Joint Committee on Taxation, rather than Congress's view

Regarding the test to determine whether the Joint Committee Staff Explanation in the 1986 Blue Book rises to the level of congressional intent, in *Redlark v. Commissioner*, 141 F.3d 936 (9th Cir. 1998), the IRS relied in part upon the Joint Committee Staff explanation of the TRA of 1986. Regarding the precedential authority of the Joint Committee Staff Explanation (i.e. "the Blue Book"), the Tax Court provided:

Nor can respondent's position be salvaged by the Joint Committee Staff Explanation. Such a document is not part of the legislative history although it is entitled to respect. E.g., *Condor Intl., Inc. v. Commissioner*, 98 T.C. 203, 227 (1992); See also *Estate of Hutchinson v. Commissioner*, 765 F.2d 665, 669-670 (7th Cir. 1985), affg. T.C. Memo 1984-55; Livingston, "What's Blue and White and Not Quite as Good as a Committee Report: General Explanations and the Role of 'Subsequent' Tax Legislative History," 11 *Amer. J. Tax Policy* 91 (1994). Where there is not corroboration in the actual legislative history, we shall not hesitate to disregard the General Explanation as far as congressional intent is concerned. See *Estate of Wallace v. Commissioner*, 965 F.2d 1038, 1050-1051 (11th Cir. 1992), affg. 95 T.C. 525 (1990); *Zinniel v. Commissioner*, 89 T.C. 357, 367 (1987), aff'd 883 F.2d 1350 (7th Cir. 1989); See also Livingston, *Supra* at 93 ("The Blue Book is on especially weak ground when it adopts anti-taxpayer positions not taken in the committee reports."). Given the clear thrust of the conference committee report, the General Explanation is without foundation and must fall by the wayside. To conclude otherwise would elevate it to a status and accord it a deference to which it is simply not entitled.

Of particular interest in *Redlark*, is a footnote in the Tax Court's opinion indicating that the TRA 1986 Blue Book is to be given even lesser respect than other Blue Books. See *Redlark*, 141 F.3d at 942.

The language quoted from the 1986 Blue Book does not otherwise appear in the legislative history of the 1986 Tax Reform Act. In addition, a \$3,000 limitation on AMT loss carryback is inconsistent with I.R.C. § 56(a)(4) which allows an AMT NOL deduction. In *Plumb v. Commissioner*, 97 T.C. 632 (1991), the Tax Court held that an

election under I.R.C. § 172(b)(3)(C) to relinquish the carryback period applies to both the NOL and the AMT NOL, the Tax Court recognizes that AMT NOLs exist separately from NOLs, and that AMT NOLs may be carried back pursuant to the rules of I.R.C. § 172.

4. Because the IRS Adopted a Position Not Authorized by Congress, Taxpayers are entitled to relief from the mandatory 5 year carryback requirement for AMT NOLs incurred in 2001.

The Job Creation and Worker Assistance Act of 2002, Pub L. No. 107-147, §102(b) 116 Star 21 (March 9, 2002) added § 172(b)(1)(h) to the Internal Revenue Code to provide a 5-year carryback period for NOLs for any taxable year ending during 2001 and 2002. I.R.C. § 102(b) of the Act states that I.R.C. § 172(j) of the Code shall be amended so as to read:

ELECTION TO DISREGARD 5-YEAR CARRYBACK FOR CERTAIN NET OPERATING LOSSES - Any taxpayer entitled to a 5-year carryback under subsection (b)(1)(H) from any loss may elect to have the carryback period with respect to such loss year determined without regard to subsection (b)(1)(H). Such election shall be made in such manner as may be prescribed by the Secretary and shall be made by the due date (including extensions of time) for filing the taxpayer's return for the taxable year of the NOL. Such election, once made for any taxable year, shall be irrevocable for such taxable year.

The IRS instructions to Form 6251 have traditionally advised that AMT loss on the sale of ISOs is not subject to the limitation of I.R.C. § 1211 (b). Based on the traditional IRS interpretation of I.R.C. §1211(b), as applied to AMT NOLs, taxpayers have been denied the ability to make important tax decisions regarding election waivers. In this light, the rigid date restrictions imposed by in Rev. Proc. 2002-40 are particularly severe. As such, forbidding a taxpayer who might learn of the ability to carry back more than \$3,000 of AMT NOLs after October 31, 2002, creates inequities based on the IRS refusal to acknowledge reasonable interpretations to I.R.C. § 1211(b) which should allow

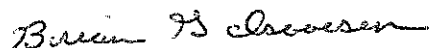
the taxpayer to make a new election under I.R.C. § 172(j) after the Court makes a judicial determination on the issues contained in this Memorandum.

Conclusion

The language quoted from the 1986 Blue Book which the Internal Revenue Service relies upon for authority that I.R.C. § 1211 limits the taxpayers loss for AMT purposes does not otherwise appear in the legislative history for TRA 1986. This language reflects the view of the Staff of the Joint Committee on Taxation, rather than Congress's view. Since the Staff of the Joint Committee on Taxation is not authorized to enact legislation imposing I.R.C. § 1211 limitations on AMT losses, Taxpayers should be allowed to carryback his AMT losses without I.R.C. § 1211 limitations. Taxpayers should also be allowed a two year carryback because the IRS has adopted an inconsistent position not authorized by Congress.

If any member of the the President's Advisory Panel on Federal Tax Reform wishes to obtain additional testimony on this proposal to have a fair alternative minimum tax, please contact Brian G. Isaacson at briani@isaacsonlawfirm.com or at (206)-448-1011. Thank you for your consideration of these important issues.

Sincerely,



Brian G Isaacson