PRESIDENT'S ADVISORY PANEL ON FEDERAL TAX REFORM

CAPITOL TAX PARTNERS

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Proposal to Provide Fair Treatment of Incentive Stock Options under the Alternative Minimum Tax

Executive Summary

One issue worthy of consideration by the Tax Reform Panel is the ever-increasing reach of the individual alternative minimum tax (AMT). Any such analysis undoubtedly would include an examination of the scope and operation of the AMT, the historical and current policy justifications for the AMT, and the revenue raised by the AMT. The purposes of this submission is to highlight the need to address one particularly egregious feature of the AMT – the treatment in a falling stock market of the disposition of stock acquired through the exercise of incentive stock options (ISOs).

As explained in detail in the attached submission, ISOs are stock options issued to broad classes of employees to encourage participation in the growth of the issuing corporation. Present law provides favorable regular tax rules that allow the deferral of the recognition of income upon the exercise of an ISO. The AMT negates this favorable tax rule by requiring taxpayers to recognize income upon the exercise of the ISOs. However, in the case of a steady or rising stock market, the AMT liability effectively "pre-paid" upon the exercise of the ISO is refunded to the taxpayer when he or she disposes of his or her ISO shares.

A discontinuity arises in the case of a declining stock markets. As illustrated in greater detail in the submission, in such cases the refund mechanism may not operate properly and taxpayers are subject to significant AMT liabilities despite the absence of economic income. Real life cases have resulted in severe economic hardship as affected taxpayers have been forced to declare bankruptcy or sell their homes, retirement security assets, or dependents' education funds in order to pay this unfair tax.

A relatively easy fix can remedy this situation – clarify that any AMT loss on the disposition of ISO shares has the same character as any AMT income recognized upon the exercise of the ISO. This solution results in the taxation of economic income, prevents taxpayer whipsaw, encourages broad employee participation in the growth of their employers, and is consistent with fundamental concepts underlying the AMT. In addition, this clarification would simplify compliance and reduce recordkeeping for individual taxpayers by "closing out" all the AMT effects of an ISO transaction upon the disposition of the stock. The solution should have a relatively modest revenue cost and presents no opportunity for abuse or tax avoidance.

Thank you for the opportunity to express this concern and for your consideration of this matter. If you have any questions, please do not hesitate to contact Joseph M. Mikrut or Jonathan Talisman of Capitol Tax Partners, Washington, D.C., at 202-289-8700.

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We are writing to request that the panel recommend modifications to the tax treatment of incentive stock options (ISOs) under the individual alternative minimum tax (AMT).[1] During the "exuberant" stock market, many taxpayers exercised their ISOs at substantial discounts and incurred large AMT liabilities. Subsequent downturns in the market, however, have caused those discounts to be "ephemeral" and the gain recognized for AMT purposes to be "illusory." Thus, upon a subsequent sale of the stock, these taxpayers typically will have a significant negative AMT adjustment. The character of this negative AMT adjustment presently is unclear.

We propose that the character of any negative AMT adjustment upon sale of the ISO stock is the same as the character of any corresponding prior positive AMT adjustment upon exercise of the ISO. This simple clarification treatment results in the taxation of economic income, prevents taxpayer whipsaw, and is consistent with fundamental concepts underlying the AMT. In addition, this clarification would simplify compliance and reduce recordkeeping for individual taxpayers by "closing out" all the AMT effects of an ISO transaction upon the disposition of the stock.

Incentive Stock Options – Current Law

Congress provided favorable tax treatment to employees who receive ISOs in order to "provide an important incentive device for corporations to attract new management and to retain the service of executives who might otherwise leave."[2] This favorable tax treatment includes no regular tax consequences to an employee when an ISO is granted or the option is exercised.

The favorable regular tax treatment for ISOs, however, does not apply for AMT purposes. Under the AMT, the spread between a stock's fair market value on the date of the ISO exercise and the

[1] We understand that the AMT presents broad policy issues. We take no position in that debate; rather, we seek to point out one of the more egregious elements of the present-law AMT.
[2] See, S. Rep. 97-144, p. 98, (July 6, 1981).

exercise price generally is a positive AMT adjustment[3] and will result in AMT liability for an employee in the year of an ISO exercise. The employee will have an AMT credit (which can be used to offset regular tax liability in future years) to the extent of such AMT liability. The positive AMT adjustment generated in the year the ISO is exercised reverses as a negative adjustment and is taken into account for AMT purposes in the year the stock is sold. The AMT credit generated in the year of the positive AMT adjustment can be used to offset regular tax liability in a subsequent taxable year to the extent the employee's regular tax liability for such year exceeds his or her tentative minimum tax (which generally will be the year of the disposition of the ISO stock because the taxpayer will have a relatively low basis in his or her ISO shares for regular tax purposes and a negative AMT adjustment). Thus, in the case of a steady or rising stock market, the AMT acts as a pre-paid tax that is effectively refunded when the taxpayer disposes of ISO shares,

The operation and interplay of the regular tax and AMT rules with respect to ISOs can be best illustrated in the following example.

Example 1—Rising market. Assume a taxpayer was granted an ISO to purchase 10,000 shares for $10 each. Over a year later, the taxpayer exercised the ISO when the fair market value of the stock was $50 per share. As a result of the exercise, the taxpayer had a positive AMT adjustment of $400,000 and a significant AMT liability. This AMT liability provides the taxpayer with an AMT credit which could be used to offset regular tax liability on sale of the ISO shares in a later year.

Over a year after the date of exercise, the stock has retained its value of $50 a share and the taxpayer sells her shares. Because she paid $10 for each of the shares, the taxpayer has a regular tax gain of $400,000 on the sale. Because she has already taken this $400,000 amount into account for AMT purposes, she will not have any AMT gain in the year of the sale. Rather, the taxpayer's income

[3] A taxpayer generally determines his or her alternative minimum taxable income (AMTI) by starting with regular taxable income and making adjustments. Positive adjustments increase the taxpayer's AMTI relative to his or her regular taxable income. Negative AMT adjustments decrease the taxpayer's AMTI.

for regular tax purposes will exceed her AMTI (i.e., she will have a negative AMT adjustment). Similarly, her regular tax liability will exceed her AMT liability and the taxpayer will to use her AMT credits to offset her regular tax liability to the extent of such excess.

Potential for Whipsaw

Declines in the stock market have highlighted a potential whipsaw under the AMT for taxpayers who exercised ISOs. The following example illustrates the problem.

Example 2—Falling market. Assume a taxpayer was granted an ISO to purchase 10,000 shares for $10 each. Over a year later, the taxpayer exercised the ISO when the fair market value of the stock was $50 per share. As a result of the exercise, the taxpayer had a positive AMT adjustment of $400,000 and a significant AMT liability. This AMT liability provides the taxpayer with an AMT credit which ostensibly could be used to offset future regular tax liability on sale of the shares.

Over a year after the date of exercise, the stock has declined in value to $10 a share. The taxpayer, seeking to avoid further investment loss, sells her shares. Because she paid $10 for each of the shares (and has a $10 basis in each share), the taxpayer does not have an economic gain from exercising the ISO and owning the shares (and does not have a regular tax gain on the sale). For AMT purposes, she has already recognized $400,000 in income in the year of the exercise which must be reversed.

At issue is how the $400,000 positive AMT adjustment generated in the year of exercise in Example 2 should reverse in the year of disposition. The employee paid AMT on $400,000 of income in the year of the exercise of the ISO. Such "income" was lost when the market retreated and she sold her shares. **To make the taxpayer whole, her AMT liability should be refunded. To accomplish this result, the law should clarify that the character of the negative AMT adjustment is the same as the prior positive AMT adjustment.**

Policy Considerations

The advocated treatment of the negative ISO adjustment is consistent with the policies underlying the individual AMT. The AMT originally was enacted to ensure that individuals with significant economic income did not escape taxation on such items of income. The taxpayer in Example 1 above has $400,000 of economic income with respect to her ISO stock over the term of the ISO transactions and is taxed on such amount. The taxpayer in Example 2 above has no economic income with respect to her ISO stock, but is subject to the same amount of tax as the first taxpayer. Clarifying that the negative adjustment has the same AMT character as the prior positive adjustment ensures that the taxpayers' taxable incomes match their economic incomes and that both taxpayers are treated fairly under the AMT.

Another fundamental notion underlying the AMT is the prepayment concept with respect to timing items. The AMT negates the benefit inherent in certain timing items by slowing down the ability of taxpayers to claim deductions or accelerating the recognition of taxable income (as in the case of ISOs). In order to ensure that the AMT operates as a prepaid tax as intended with respect to ISO transactions, the negative ISO adjustment must have the same character as the prior positive adjustment.

Clarifying the treatment of the negative ISO adjustment will simplify tax compliance. For many individuals, the ISO adjustments will be the only significant AMT adjustments they will experience. Clarifying that all the AMT effects of an ISO transaction end in the taxable year that the ISO stock is disposed of will reduce recordkeeping and the need to enter into transactions to ensure the utilization of AMT credits. Finally, by only taxing economic income, the advocated position does not create any loopholes or potential for abuse.

Thank you for your consideration of this matter.