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Tax trap waiting to happen

Couple's windfall turns nightmarish as holding onto stock incurs \$300,000 bill

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Easter dinner this year at the Beloit home of Julius and Barbara Pellegrini was supposed to be a joyous occasion.

Gathered around the table of the retired schoolteachers were their children and grandchildren from throughout the state, happy in the magical way that comes from a family eating a good meal together.

Then the phone rang.

On the other end was Cari, short for Carolene, a 44-year-old daughter who lives in Flower Mound, Texas. Even now, both she and her 71-year-old mother become emotional when remembering the subject of the call: taxes.

That might seem like a peculiar topic to dampen a festive family dinner, but by the time Cari called Wisconsin to ask for help, she was in the fifth year of a dispute with the Internal Revenue Service and afraid she might lose her house.

The situation was "extremely stressful, on a marriage, on a family, on everything else" said Cari's husband, John C'deBaca, 38, who amassed files about three feet thick as the dispute dragged on.

Cari and John had fallen into a trap that, in retrospect, even they admit was entirely avoidable. It was the consequence of a lack of knowledge on their part, and a gamble encouraged by the tax laws.

And while their situation is limited to just thousands of the more than 120 million U.S. taxpayers, its lesson is universal - if you are going to make a financial bet, get all the facts, and then use your head, not your heart, to figure the odds.

Typical dot-com firm

The problem started in late 1998, when Cisco Systems Inc. completed its purchase of Selsius Systems

Inc. in Dallas. Selsius was an enterprise typical of the go-go dot-com '90s. It developed a switching system for sending voices over the Internet, and as such, caught the eye of Cisco, the giant Internet networking firm based in San Jose, Calif.

Cari C'deBaca had been working for Selsius for about three years. She came to Texas to complete college after graduating from Beloit's F.J. Turner High School in 1979.

At Selsius "we had only 53 people; it was a total start-up," she said. "We didn't have titles; everybody did everything." And even if the pay was low and the hours long, "it was the best years that I ever had."

At the time of the sale to Cisco, it seemed to be the most rewarding, too, because her equity stake in the start-up was converted to incentive stock options in Cisco. That gave her the right to buy Cisco shares for a guaranteed fixed price.

At the time the sale closed, Cisco stock was worth \$18.84 a share, but by March 2000, as the tech bubble inflated, it touched \$80.

All of a sudden, she was sitting on a gain of about \$1 million.

To get the money, C'deBaca had to exercise her options to buy the Cisco shares and then sell them immediately on the open market.

Selling at least some of the stock seemed like a good idea. It would diversify her investments, allow her to save for her child's education and help her parents.

Because there were several old Selsius employees in the same situation, her boss at Cisco brought in an accountant from Arthur Andersen to explain how the options worked, C'deBaca said. Later, she and her husband also turned to Andersen for advice on how to structure their financial lives now that they had such newfound wealth.

In April 2000, she started the process, exercising her option to buy 8,400 shares of Cisco for \$1.58 each. Cisco was then selling at \$67.75, giving her a profit of \$555,828. In September she exercised her options for an additional 6,924 shares at \$1.58. Cisco had fallen to \$59.3125, meaning her profit was \$399,739.83.

One thing the C'deBacas had learned was that, from a tax perspective, it would be a good idea to hold on to the Cisco stock for at least a year after Cari exercised her options. That would make the profit from the sale of the stock a long-term capital gain, which is taxed at a much lower rate than short-term capital gains.

Furthermore, doing so seemed like a good idea to her.

"I wanted to do the right thing, stay in for the long term," she said.

True, the stock was bouncing around, but C'deBaca attributed that to day trading.

Owed more than \$300,000

What the C'deBacas had not realized was that, under the alternative minimum tax law, federal taxes on the gain were due when the options were exercised. The amount paid could later be used as a credit

against any capital gains taxes due when the shares were sold.

Thus, when the C'deBacas filed their 2000 income taxes, they owed the federal government more than \$300,000.

The returns were prepared with the help of David House, a CPA in Dallas, whom they had not consulted before exercising the options.

While reluctant to discuss the specifics of the C'deBacas' return, House said he's had several clients who fell into a similar situations.

"My advice to people at the time who came to consult with me is you can't afford to wait a year (to sell the stock), you have to sell at least enough to pay the tax and then take the gamble with the rest of it," he said. "What it really boiled down to is people got stuck in the optimism that tech stocks had nowhere to go but up and there was no risk in waiting" to sell.

That is how the C'deBacas saw it. "We never talked about what happened when the stock goes down," Cari said.

But it did.

By the time their taxes were due in April 2001, Cisco stock had fallen to about \$14 a share. C'deBaca sold most of hers for \$14.08. That was still a nice gain from \$1.58, but the approximately \$215,000 she got after commissions and other costs was not enough to pay her taxes. The stock is still well below what the C'deBacas had planned on five years ago - Friday, it closed at \$17.72.

Still, in 2001, the taxes were due, and interest and penalties began to pile up as well.

'Like dealing with the mob'

The couple spent years trying to get the IRS to lower the amount due through a so-called offer in compromise. That is a procedure through which the agency can accept less than the full amount due if a taxpayer makes a good case he can't pay it.

But according to John C'deBaca, the agency would not budge on its demands.

"It was like dealing with the mob," he said. "I've got a whole forest (of correspondence) in my garage . . . Most of them are form letters: 'We got your response. We understand you don't have any money but send us' " the taxes anyway.

The IRS declined to discuss the case, citing a federal law that makes it illegal to disclose information about individual taxpayers.

However, this year in a case similar to that of the C'deBacas involving a couple from Iowa, the U.S. Tax Court upheld the IRS position. The opinion said, in part:

"Congress is well aware of the claimed inequities resulting from the application of the AMT and has, so far, declined to act. . . . In many different contexts, literal application of the AMT has led to a perceived hardship, (but) . . . the solution must be with Congress."

A bill to address the situation faced by the C'deBacas failed in the last Congress, and another has been introduced this year in the House but has not had a hearing.

Family rallied around

Eventually, through sending the IRS money monthly, the C'deBacas, both of whom have well-paying jobs, were able to clear the tax liability, cleaning out their savings and other investments to do so.

But then, just before Easter, the IRS put a lien on their property looking for about \$116,000 in additional penalties, leading to the phone call to Beloit, a step they had long resisted.

The Wisconsin branch of the family rallied around and lent them the rest of the money to pay the IRS.

In addition to teaching lessons about researching financial transactions, John C'deBaca says he remains wary of the IRS and tax laws.

"Now I fear the government," he said. "I think they are going to try to come back and get me."

And he sees an unfortunate irony.

"Cari had felt she was the one to take care of her parents, not the other way around."

Journal Sentinel correspondent Kate Goodloe contributed to this report from Denton, Texas.

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