ISOs Meet The AMT: Employees Ambushed by the Tax Code

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In this report, Sommers describes how the AMT caused economic ruin to thousands of middle-class workers who exercised incentive stock options during 2000. Sommers traces the history of the AMT as applied to employee stock options, using a taxpayer’s actual circumstance to illustrate how the tax law produced this financial crises. Sommers offers several legislative solutions, and suggests how IRS should apply the offer-in-compromise process to achieve a fair and equitable result.
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SUMMARY OF THE PROBLEM

The New Economy\(^1\) plays by new economic rules and uses new forms of compensation. Cash plus an interest in a company lures millions of employees to work 60 to 80-hour weeks for years, in hopes of a huge payoff. Workers gladly receive company stock options\(^2\) because if the company goes public\(^3\) their options could instantly be worth millions – or so they thought. In March 2000, when the NASDAQ bubble burst, even the strongest companies in America were not spared the collapse.

These workers understood their stock could lose value and, just like every investor, they accepted the financial risk by holding their company’s stock. But many failed to notice that an antiquated tax system was ready to pounce on them, once they exercised their options. Some paid withholding taxes upon exercise; many found out only when their tax returns were prepared the following year.

Unlike investors who purchase stock, employees are taxed on the “spread”\(^4\) when they exercise their options, not when they sell their stock. Rules developed 30 years ago to ensure the wealthiest would pay their fair share of taxes, roared-up and bit these workers, without regard to their level of income or job title – from president and CEO, to secretaries and receptionists – no one was spared.

Rules enacted to tax employee stock options upon exercise failed to provide safeguards in case that stock’s value plunges before it was sold. Our tax system, which usually taxes a transaction when there is a sale or disposition, not when an asset is received, failed these workers and as a result, many now owe more in tax than their stock is worth; indeed, many owe more in tax than their entire current net worth.

1 EMPLOYEE STOCK OPTIONS – THE NEW GOLD RUSH

1.1 Jeff Accepts a Job in the New Economy

Jeff, a bright, young computer engineer, went to work in Silicon Valley and took a job as a computer-chip designer for a start-up called Granite Systems. He had no idea that the incentive stock option (ISO) he received would cause his financial ruin. Jeff, as many workers in the New Economy, was prepared to work 60-80 hours a week in return for the opportunity to make huge profits if his company went public.

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\(^1\) The New Economy refers to high-tech and Internet companies involved in creating or using the latest technologies. These companies are either start-ups designed to go public or are companies listed on the NASDAQ.

\(^2\) An option is the contract right to acquire a certain number of shares at a stated price per share for a fixed period of time. Employee stock options provide workers an opportunity to share in a company’s financial success by permitting them to purchase the company’s stock at a favorable price (at least in theory). Usually, conditions are attached to the exercise of stock option, ensuring that the employee will work for the company for a minimum number of years.

\(^3\) Going public refers to the company’s initial public offering (“IPO”) of stock on a publicly traded stock market. When a company has a successful IPO, its stock value can skyrocket.

\(^4\) The “spread is the difference between the fair market value of the underlying stock at the time of exercise and the option price paid.
Jeff received an option to purchase 80,000 shares at $0.05/share when the stock was worth $0.05/share. Jeff understood that his option would “vest” over a 4-year period. About three weeks after Jeff joined Granite, the company was acquired by CISCO, which continued Granite’s employee stock option plan, adjusting Jeff’s options accordingly. Now, incredibly, Jeff owes $1 million more in taxes than his stock is worth and he is financially insolvent.

Jeff’s story is being replicated throughout the country. It is an example of how a tax monster called the Alternative Minimum Tax (AMT) is thrashing the lives of many workers, from corporate officers to the rank-and-file, throughout the New Economy. Here is what happened:

1.2 Jeff Exercises his Stock Options

In March 2000, Jeff exercised his options in CISCO. This was consistent with the prevailing wisdom of exercising in the first 3 months of the year to obtain long-term capital gains (LTCG) treatment if one sold the shares at least 12 months later. Proceeds could be used to pay taxes due April 15th of the following year.

When Jeff exercised his options, no warnings were issued; Jeff received no notice from his employer pertaining to his potential AMT liability and no taxes were withheld. However, Jeff had just triggered the dreaded AMT, which is calculated at the stock’s price on the date of exercise, regardless of the stock’s price in the future. When Jeff exercised his options, his stock was worth an average of $65/share. If he sold the stock within 12 months of exercise (or within 24 months of grant) he would have made a “disqualifying disposition” and paid ordinary income tax at a maximum federal rate of 39.6%. If he held the stock for at least 12 months before sale, his maximum federal tax rate would be 20%, nearly 50% less.

By March 2001, CISCO’s stock was languishing below $20/share, a drop of more than three times the stock price when Jeff exercised his ISO.

1.3 Incentive Stock Options

Jeff received an ISO, a special type of stock option reserved for employees under IRC Sec. 422. An ISO provides a tax incentive to employees who remain employed by their companies because, supposedly, they are not taxed upon exercise, and a later sale of the stock qualifies for long-term capital gain treatment. In 1981, the Senate Finance Committee provided the following justification for an ISO:

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5 Jeff’s option was subject to a typical four-year “earn-out” provision in which he would own (“vest”) 25% of the option after 12 months of service, and then 1/48 per month for months 13 through 48.
6 The merger called for CISCO to issue 0.221992 shares of its stock for every share of Granite’s stock, so Jeff’s ISO was reduced from 80,000 shares at $0.05/share to 17,759 CISCO shares at an exercise price of $.2252/share. At the time, CISCO’s shares were trading at approximately $60/share, so Jeff’s spread instantly jumped to $1,065,540. Subsequently, CISCO’s stock split 3:2 in December, 1997; 3:2 in September, 1998; 2:1 in Jun 99 and 2:1 in March, 2000. After the splits, Jeff had 159,831 shares with an exercise price of $0.025/share.
7 Incentive stock options are also called “statutory options” because they must meet the requirements of IRC Sec. 422.
8 IRC Sec. 421(a). Long-term capital gain treatment is accorded, provided the employee does not sell the stock for at least two years from the date the option was granted and one year from the date the option was exercised. In addition the employee, in general, must remain employed with the company during this period and the option
The committee believes that reinstitution of a stock option provision will provide an important incentive device for corporations to attract new management and retain the services of executives who might otherwise leave, by providing an opportunity to acquire an interest in the business. Encouraging the management of a business to have a proprietary interest in its successful operation will provide an important incentive to expand and improve the profit position of the companies involved.  

Clearly, the purpose for permitting special treatment for incentive stock options was to attract corporate management committed to, and with a vested interest in, the company’s long-term success, thereby increasing the value of the stock.

1.4 Non-Qualified Stock Options

In contrast, non-statutory options (non-quals), are employee options that do not meet the IRC Sec. 421(a) requirements. For both ISOs and non-quals, tax consequences are triggered when the employee exercises the option. Non-quals are taxed upon exercise under IRC Sec. 83(a), which governs the receipt of property in connection with the performance of services.

Unlike a non-qual, the exercise of an ISO does not trigger an immediate tax under the regular tax system, but the spread falls within the AMT regime. The AMT ignores the special provisions relating to ISOs under IRC Sec. 421(a) and treats them as non-quals under IRC Sec. 83(a), but applies AMT rates.

1.5 Section 83(b)

When Jeff received his stock options, he could not take advantage of Section 83(b) – the first tax code provision that could have eliminated his ultimate tax plight. When property (including stock) is received in connection with the performance of services, Section 83(b) permits an election to be taxed on the fair market value thereof when the property is received, without, in general, taking into consideration any substantial restrictions on the property (such as vesting). Jeff would have been taxed immediately on the spread between the option price and the fair market value of the shares.

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10 Non-statutory options are often called non-qualified options or “non-quals.”
11 Non-statutory employee options are taxed under IRC Sec. 83, which deals with the receipt of property for services. Generally, non-quals are taxed as compensation at the time they are exercised, provided the stock received is vested (i.e. not subject to a substantial risk of forfeiture).
12 For example, if an employee exercises an option to purchase 10,000 shares by paying an option price of $1/share when the fair market value of the underlying stock is $50/share, for AMT purposes, there is income of $490,000 (spread per share is $50-$1 = $49; $49 x10,000 shares = $490,000).
and the fair market value of the stock received. Unfortunately, Sec 83(b) does not usually apply to stock options.

1.6 Early Exercise and the Sec. 83(b) Election

Jeff could have used Section 83(b) if his company, Granite, had an “early exercise” program. Jeff would have exercised his options immediately and Granite would have retained the right to repurchase the stock if he failed to meet the vesting provisions. Because Jeff would own the stock, he would be eligible to make an IRC Sec. 83(b) election.

Unfortunately for Jeff, Granite did not offer an early exercise program. Granite was an S corporation, rather than a traditional C corporation, and although there is nothing preventing an S corporation from offering an early exercise program, there could have been accounting complexities unique to S corporations if Jeff became a shareholder and later forfeited stock under the original stock purchase agreement. Unfortunately, Granite’s corporate status prevented Jeff from using Sec. 83(b) to lock in the spread for AMT purposes when that spread was smallest.

1.7 Managing the “Spread” on Employee Stock Options

The most critical factor determining the tax consequences of both ISOs and non-quals is the size of the spread at exercise. The greater the spread, the larger the tax.

Taxing the spread at the time of exercise, rather than when the stock is actually sold or otherwise disposed of is a significant departure from traditional tax rules. It is this deviation from established tax principles that has caused the catastrophe to many workers in the high-tech industry.

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13 As discussed in the text accompanying footnote #16, if Jeff’s spread was $0.05/share and he exercised 80,000 options, his taxable income would be $4,000. More importantly, just $4,000 (the spread on his ISO stock) would have been subject to the AMT.

14 Early exercise allows the employee to exercise his options immediately, while the vesting schedule remains in place. Instead of earning stock over time, the employee owns 100% of the stock immediately, but the company is given the right to repurchase the stock according to the vesting schedule (which now becomes a repurchase schedule). Typically, the company insists that the stock be held in escrow during the time the company has repurchase rights. Functionally, owning an employee stock option subject to vesting is the same as owning all the stock immediately, subject to the company’s right to repurchase; however, under the early exercise approach, the employee elect IRC Sec. 83(b) to lock-in a small spread and usually eliminate the AMT.

15 Because an S corporation is a “flow-through” entity, gains and losses are usually reported by shareholders on their individual tax returns, rather than reported by the corporation. Under an early exercise program, Jeff would have been entitled to his pro-rata share of the S corporation’s income and loss immediately, even though the company intended that his ownership rights accrue over a 4-year vesting period.

16 For example, assume Jeff has an option to purchase 80,000 shares at $0.05/share. If he exercises all his options when the stock’s fair market value is $1, the spread is $0.95/share and Jeff will have $76,000 ($80,000 less exercise price of $4,000 = $76,000) of ordinary income for non-quals and the same amount as under the AMT for ISOs. In contrast, if Jeff could have elected immediate taxation under IRC Sec. 83(b), his income would have been limited to $4,000, the fair market value of the stock, (assume, $0.10/share) less the option price of $0.05/share ($8,000 less $4,000 option price = $4,000). His tax liability on any stock appreciation above $1/share occurs when the stock is sold.

17 The taxation event occurs when stock is sold, exchange, abandoned, becomes worthless or otherwise disposed of in a taxable transaction.
With non-quals, the spread is immediately taxed as compensation; with ISO’s the spread is taxed the same as non-quals, but under AMT rules. In either case, taxing the spread at the time of exercise, without allowing an alternative valuation mechanism when the spread subsequently collapses (and the asset is worth a fraction of the exercise value), is contrary to our system of taxation. More importantly, it creates a tax wholly disproportionate to the actual value of the asset upon sale.

1.8 Stock Options Require Investment Sophistication

There is widespread confusion among employees who own stock options. An article appearing in SiliconValley.com referred to an OppenheimerFund survey which found that:

75 percent of the stock-option holders weren’t familiar with the Alternative Minimum Tax, and that 52 percent knew “little” or “nothing at all” about the tax implications of exercising options. More than one in three couldn’t say whether they held incentive stock options or the more common non-qualified options.

Employee stock options blur the distinction between workers and investors. Employees working for a paycheck do not instantly become experienced, sophisticated short-term investors just because they exercise their company’s stock options. They should not be ruined financially because they failed to immediately sell those options, especially when few of the so-called market experts had any indication of the impending NASDAQ collapse. The financial decision to sell stock is often a complicated one and novice investors invariably rely on these experts.

Certainly every stockholder should be subject to identical investment risk of loss if a stock drops and should determine their taxes based on the value of the stock when sold. The tax law should not punish employees just because they did not comprehend the AMT consequences when they exercised their options, especially when the stock’s value, in hindsight, was greatly inflated. Employees should be taxed when they sell their stock, just like every other investor.

If Granite offered its stock directly to outside investors, rather than to Jeff through an ISO, those eligible to purchase it would have to meet “accredited” investor requirements imposed by the SEC, because the investment would be deemed risky. Yet companies are permitted to offer employee stock options, often in lieu of regular compensation, without adequate disclosure or access to the financial and tax expertise necessary to deal with such investments.

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18 The article was titled, Tax Disaster blindsides some who exercised stock options

19 Generally, an accredited investor is an individual (including his spouse) with a net worth exceeding $1 million or the individual must earn more than $200,000 ($300,000 if married) per year.

20 Start-up companies frequently offer employees lower salaries in exchange for stock options to reduce their payrolls. In these instances, stock options are used to shrink overhead, rather than as an incentive for top management to make the company profitable.
1.9 The ISO AMT Tax Trap

There are two advantages to ISOs when compared to non-quals: (1) LTCG - if the employee meets the ISO holding periods, any profit on the stock will be taxed as long-term capital gains and (2) Deferral of Tax - the employee does not have to pay ordinary income tax at the time of exercise;\(^{21}\) instead, the employee is taxed under the regular tax system when the stock is sold, which could be years later.

However, these advantages can be dwarfed by the imposition of the AMT rate, often as high as 28%\(^{22}\), which is eight percentage points higher than the LTCG tax rate of 20% and is 11.6 percentage points lower than the highest ordinary income tax rate of 39.6%\(^ {23}\).

1.9.1 The LTCG Benefit

ISOs are treated as non-quals for AMT purposes, which means, in general, they are taxed under IRC Sec. 83(a) on the spread at the time of exercise\(^{24}\), but at AMT rates rather than ordinary income rates. While the exercise of a non-qual is treated as compensation that requires withholding taxes upon receipt of that stock, no such withholding requirement for the AMT is imposed on ISOs. If the employee continues to hold his company’s stock after exercising an ISO, he is gambling with tax dollars owed to Uncle Sam, whether he realizes it or not. Jeff triggered a punishing tax event, because exercising an ISO is a tax item under AMT rules and the spread is income.\(^ {25}\)

1.9.2 The Deferral Benefit

There is no longer a benefit associated with deferring taxes to a future year, because an employee is required to pay AMT in the year of exercise. For example, assume a taxpayer exercises ISOs with a spread of $1,000,000 and assume the AMT totals $280,000. Even if the taxpayer sells the stock 3 years later for the same price per share (i.e. $1,000,000 profit), his federal LTCG tax will be $200,000. Thus, there is no economic advantage to deferring income taxes.\(^ {26}\)

Moreover, the taxpayer paid $280,000 in AMT but only $200,000 will offset the LTCG tax when the stock is sold. The $80,000 balance is considered an AMT credit under IRC Sec.

\(^{21}\) IRC Sec. 421(a)(1).

\(^{22}\) The AMT has two tax rates, 26% for the first $175,000 of Alternative Minimum Taxable Income, determined after exemptions and, in general, 28% on the excess.

\(^{23}\) The pending tax reform legislation may reduce the highest tax rate to 33% which means the difference between ordinary income tax rates and the AMT will be 5 percentage points.

\(^{24}\) The ISO spread is taxed under IRC Sec. 83(a). In general, the stock’s fair market value is determined at the time the stock is received. If the stock is not freely transferable or is subject to a substantial risk of forfeiture, the fair market value is determined when either of these conditions no longer exist.

\(^{25}\) For example, if the FMV of the stock was $80/share and the exercise price was $5/share, the spread would be $75/share. If Jeff exercised 100,000 options, his spread would be $7.5 million. Under the AMT, this $7.5 million could be taxed as high as 28%, thus, Jeff would immediately be liable for $2,100,000 in federal taxes under the AMT, payable by April 15\(^{th}\) of the following year.

\(^{26}\) If AMT is eliminated for ISO’s there could be a tax benefit for deferral. This could be easily remedied by charging interest on the taxes that have been deferred.
53 that may be used in subsequent years, but unless there is a large capital gain in future years, it could take several generations to exhaust the AMT credit.27

1.10 AMT and Disqualified Dispositions

Prior to the elimination of qualified options in 1976, the spread was considered a tax preference item under then-existing minimum tax provisions. When ISOs became part of the law in 1981, initially they were not subject to the AMT. That changed the following year, when Congress enacted the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA). The Congressional history of TEFRA made it clear that the AMT should only apply when the employee was eligible for capital gains treatment. If the employee made a disqualified disposition, the AMT would not be imposed:

In addition….a preference is added for the excess of the fair market value of stock received upon the exercise of an incentive stock option over the exercise price. It is intended that the incentive stock option preference not apply where there is an early disposition of the stock acquired through the exercise of the option. 28 [emphasis added]

The General Explanation of TEFRA, page 19, confirms that the AMT does not apply if the special capital gains treatment provided an ISO is denied because of an early disposition:

Furthermore, a preference is added for the excess of the fair market value of stock received upon the exercise of an incentive stock option over the exercise price. It was not intended that the incentive stock option preference apply, however, where the special tax treatment for incentive stock options does not apply because there is an early disposition, as specified in section 422A(a)(1), of the stock acquired through the exercise of the option. [emphasis added]

According to the legislative history, a disqualifying disposition, even if it occurs after the year in which the ISO is exercised, should have removed the spread from the AMT.29

Despite the clear intention of Congress that AMT not apply to early dispositions of ISO stock, Congress changed the AMT treatment of ISOs in 1986 and in the process, passed IRC Sec. 56 (b)(3) which provided that the AMT is eliminated only if a disqualifying disposition

27 In many cases, the AMT credit will never be used. The AMT credit applies in future tax years only when, in any given year, the regular tax exceeds the AMT, and then only to the extent of the difference. Because the AMT is not currently adjusted for inflation, it will become the primary tax for millions of taxpayers. Therefore, as a practical matter, the AMT credit may never be used, unless the taxpayer has a large capital gain in the future.

28 H.R. No 97-760, page 475.

29 For example, if a taxpayer exercised an ISO, the company transferred the stock on March 30, 2000, and the taxpayer sold the stock on March 29, 2001, a disqualified disposition would have occurred since the taxpayer did not hold the stock for one year. Assume the spread was $75/share on the date of exercise (the value used for the AMT) and $5 only on the date of disposition, the taxpayer should pay ordinary income tax on the $5/share spread rather than AMT on the $75/share spread. Assuming maximum tax rates apply, the taxpayer will pay 39.6% federal on $5/share spread ($1.98/share tax) compared to 28% federal on $75/share spread ($21/share tax). If the sale involved 100,000 shares, the resulting tax would be $198,000 under the early disposition rules, rather than $2.1 million under the AMT regime.
occurs in the same tax year in which an ISO is exercised. The taxpayer in the example contained in footnote #28 would owe $21/share of AMT despite an early disposition of his stock because the disposition occurred in a later year.

Under IRC Sec. 56(b)(3), taxpayers who failed to sell their stock by the end of 2000 were automatically subject to AMT based on the spread at exercise, even though their stock dropped dramatically during the first quarter of 2001. Had the original congressional intent been enacted into law, taxpayers could have bailed out of the AMT trap by selling stock within 12 months; thus if a taxpayer exercised an ISO and the corporation transferred the stock on March 30, 2000\(^{30}\) his deadline to avoid the AMT would have been March 29, 2001, instead of December 31, 2000.

1.11 The Disqualified Disposition Tax Trap

Workers who believed in their companies and wanted to maintain their investment, yet avoid the imposition of the AMT on a non-existent spread may have thought they could just immediately repurchase their stock after sale. Others may have reasoned they could gift the stock or sell it to a family member to avoid the AMT. Wrong!

A little-noticed provision in the tax code permits a disqualified disposition to be taxed without AMT consequences only if the loss from the disposition, “if sustained, would be recognized.”\(^{31}\) This means the stock must be disposed of in a transaction in which the taxpayer would have recognized the loss on his tax return. Unfortunately, there are several tax code provisions that prevent a loss from being recognized.

If an employee repurchases stock in his company within 30 days prior to or after the disposition, then the wash sales rules of IRC Sec. 1091(a) deny the loss.\(^{32}\) Also, there is no loss recognized with a gift transfer, or a sale to a related party under IRC Sec. 267 (a)(1). Prop. Reg. 1.422A-1 (b) (2) contains an example where a disqualified disposition sale to a family member in the same year of exercise did not prevent the AMT because the loss would not have been recognized under IRS Sec. 267.

Apparently, it seems that few were aware of this rule. Apparently, brokers who told their clients to sell by the end of the year to avoid AMT and to reacquire the stock, quickly asserted that they were not tax advisors and the client was responsible for the tax consequences of their investments. One commentator made the following observation concerning this bad tax advice:

What is more remarkable is that a rule of so great importance to so many people is so little known. During November 2000, both the Wall St. Journal (in a front

\(^{30}\) Under IRC Regs. §1.421-7(g), the holding period begins when the corporation transfers of ownership of such share to the employee (or the transfers of substantially all the rights of ownership). The transfer it must be recorded in the corporate records within a reasonable time after it occurs.

\(^{31}\) IRC Sec 422(c)(2) involves the elimination of AMT if the year of exercise and disposition are the same, provided that "such disposition is a sale or exchange with respect to which a loss (if sustained) would be recognized to such individual."

\(^{32}\) In general, IRC 1091(a) applies to the sale and acquisition of "substantially identical" stock or securities, which clearly includes common stock sold and repurchased in the same company.
page tax column) and Business Week magazine described the need to sell depreciated ISO stock before the end of the year and told their readers they could purchase replacement shares if they wanted. There is reason to believe a large number of option holders are receiving similar advice from financial advisors who are unaware of this rule.  

1.12 Lack of Information Regarding the Disqualified Disposition Tax Trap

In Tax Management Portfolio (TMP), Portfolio 381-2nd, entitled Statutory Stock Options, considered a leading source of tax information by attorneys and accountants, this issue is not discussed either. TMP amended the portfolio in May 2001 and the updated version now discusses this trap. There is no mention of the problem in the CCH Standard Federal Tax Reporter explanations either, although one finds the proposed regulation within the tax service. IRS Publication 525 (dealing with employee stock options) discusses ISOs, but fails to mention the interplay between a disqualified disposition and the wash sales rules.

According to Michael Gray, TurboTax, a leading tax software package evidently used by millions to prepare and file their income taxes, did not include this rule as part of its tax interview process. Thus, in situations where the loss would not be recognized, those preparing their own taxes with this software would have improperly claimed disqualified disposition treatment on the sale of their stock.

As a nation, we have developed a tax system with rules so obscure that even leading financial and business magazines, newspapers, tax experts and major tax publications are unaware of and cannot provide accurate information to taxpayers, until the problem comes to light after many have fallen into the trap.

1.13 Taxing Net Worth Rather Than Realization Upon Sale

Both ISO and non-quals are taxed on the spread upon exercise, an accrual concept of taxing wealth on a specific valuation date. In addition, the stock is taxed again under the traditional “realization” concept when it is sold. In discussing the appropriate time to extract a tax, Bittker and Lokken, Federal Income Taxation of Income, Estates and Gifts, second edition (Bittker and Lokken), stated:

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34 IRS’s audit manual for its agents, under its Market Segment Specialization Program, Alternative Minimum Tax for Individuals, TPDS No. 84294S (12-1999), failed to mention this rule as well. Therefore, IRS auditors conducting an examination would be unaware that the AMT continues to apply if the taxpayer disposes of ISO stock in the year of exercise, when the loss from the disposition is not recognized.

35 Mr. Gray is co-author of Employee Stock Options – A Strategic Planning Guide for the 21st Century Optionaire.

36 Michael Gray, ESOAA. In Option Alert #6 entitled, “An irregular alert for issues relating to employee stock options,” February 6, 2001 (www.stockoptionadvisors.com). Mr. Gray noted that TurboTax recently added the general disqualified disposition rule in an update, but failed to mention the wash sales rule relating to the early disposition of ISO shares. Also, he claims that TurboTax did not inquire about minimum tax credit carryover information from previous years and that AMT basis adjustments did not properly carryover from the federal return to the California return. Apparently, tax software programs cannot accurately calculate the AMT.
The Haig-Simons definition of income calls for periodic valuations of the taxpayer’s assets and liabilities so that increases and decreases in net worth can be taken into account as they accrue. With minor exceptions, however, gains and losses are taken under present law only when realized by sale, exchange, abandonment, or other disposition. The realization approach defers tax on accrued but unrealized gains and losses.

Taxing an asset based on accrued wealth, rather than realized gain or loss, as Bittker and Lokken observed:
would require taxpayers to pay tax on gains that have not been reduced to cash; taxpayers whose unrealized gains are high in relation to their money incomes would face a cash squeeze, particularly if the unrealized gains were in assets that were difficult to sell or could not be sold without disrupting the taxpayer’s business.

The current system determines the tax on realization, rather than accrual of phantom gains, because the actual gain or loss can be accurately measured only when the asset is sold and has been reduced to cash. Also, taxes can be paid from the proceeds.

Stock options, however, are taxed when the stock is received and the wealth accrues. This can cause a tax calamity if the stock is not immediately sold and subsequently plunges in price. Ironically, the incentive for employees to retain stock in their corporations for the long term is obliterated by a tax law that requires the employee to sell immediately or face potential financial disaster should the stock price drop dramatically. Using an accrual approach to tax employee stock options is inappropriate because of the stock’s potential instability.


IRC Sec. 83(a) taxes property received through the performance of services. Theoretically, there should be no difference between receiving $1,000 cash and an asset worth $1,000 as compensation; both should be taxed identically. The problem arises when the asset’s value is extremely volatile and can be worth 10x or 1/10x its original value within weeks. IRC Sec. 83(a) concept of taxing property at its fair market value on date of receipt can cause serious dislocations if the value abruptly increases or decreases.

Taxing an asset as to its fair market value on the date of receipt, rather than when it is sold, assumes the asset can be sold freely and without adverse consequences. Often, employee stock cannot be sold immediately. There may be restraints on the stock under securities laws or by underwriters and investors. Also, the company may have policies and restrictions regarding employee stock sales.

Even if the stock could be sold immediately, the accrual concept places a premium on becoming a successful speculator and severely punishes those who hold their stock because they believe in the long-term goals of their company, the original intent of ISOs, if the stock’s value deteriorates.
1.15 Does the AMT Violate the Fifth Amendment?

Although the Fifth Amendment is not a direct limit on Congress’s taxing authority, there could be a violation of the Fifth Amendment if the tax is so high, it amounts to a confiscation of property. *Brushaber v Union Pac. RR.* The Court noted that the due process clause could apply:

> [If] the act complained of was so arbitrary as to constrain to the conclusion that it was not the exertion of taxation but a confiscation of property, that is, a taking of the same in violation of the Fifth Amendment, or, what is the equivalent thereto, was so wanting in basis for classification as to produce such a gross and patent inequality as to inevitably lead to the same conclusion.

With respect to the limitation of Congressional taxing authority, one early commentator noted:

> [There] is no more incongruity in having the federal taxing power limited by the Fifth amendment than in having state taxing power limited by the Fourteenth Amendment. The existence of power on the one hand and the constitutional restrictions on its exercise on the other is of the essence of our constitutional system. To borrow the simile of [a prior author], a train is not self-destructive because it has both motive power and brakes.\(^{38}\)

Many taxpayers are facing an AMT that exceeds the value of their stock by several times; indeed for some, the AMT surpasses the value of their entire net worth by an astonishing six or seven figures. The AMT, in these situations, clearly amounts to confiscation of property and, because of the severity of the tax, could violate the due process clause of the Fifth Amendment.

In addition, the argument could be made that the sheer complexity of the AMT violates the due process clause because a large segment of average taxpayers cannot understand it. At some point, a law can be so complex and incomprehensible to those who must abide by it that the law could violate the Fifth Amendment’s due process clause.

Whether or not the extreme application of the AMT approaches a constitutional violation of due process, it is fair to say that as applied to stock options, the AMT can cause financial ruin and is manifestly unfair and inequitable to those who stumble into its trap.

2 PROPOSED SOLUTIONS

2.1 Tax Stock When it is Sold, not When the Option is Exercised.

The appropriate time to tax a stock transaction is when it is sold, a change that would favor employees receiving both ISOs and non-qualified stock options. It would also greatly

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\(^{37}\) 240 U.S. 1 (1916).  

simplify the tax treatment of these options, providing clear, non-contradictory tax guidelines. Further, this change would eliminate ISOs from the AMT. 39

To eliminate potential deferral abuses, the stock could be considered sold or disposed of if the taxpayer makes any stock transfer (except to a grantor trust or upon death) or in any way encumbers the stock or uses it as collateral for a loan. Any short sale or other hedging technique could be considered a sale as well. Rules of IRC Sec 1259 relating to constructive sales of appreciated financial positions 40 could apply and be expanded to eliminate any financial benefit arising from that stock’s ownership, other than as an investment.

2.2 Eliminate the AMT but Tax the Spread as Ordinary Income

Congress could change the law so that upon sale of stock acquired through an ISO, the spread at the time of exercise could be considered ordinary income and the balance of the gain (provided the stock sale price is greater than the spread at exercise), could receive capital gains treatment. This might be an appropriate trade-off for the benefit of not paying AMT based on the spread at time of exercise.

2.3 Limit AMT to Truly “Wealthy” Taxpayers

The minimum tax (forerunner to AMT) was enacted in 1969 because Congress believed that wealthy taxpayers should not radically reduce their tax burden by using various tax deductions and preferences in the tax code. Wealthy taxpayers were those with adjusted gross incomes of $200,000 or more, based on 1964 dollars. The Senate Report described the problem as follows:

The present treatment which permits individuals and corporations to escape tax on certain portions of their economic income results in unfair distribution of the tax burden. This treatment results in large variations in the tax burdens placed on taxpayers who receive different kinds of income. In general, high-income individuals, who get the bulk of their income from personal services, are taxed at high rates. On the other hand, those who get the bulk of their incomes from such sources as capital gains or who can benefit from depreciation on real estate pay relatively low rates of tax. In fact, individuals with high incomes who can benefit from these provisions may pay lower average rates of tax than many individuals with modest incomes.

For example, in 1964, the 1,100 returns with adjusted gross incomes over $200,000 paid an average tax of 22 percent of economic income. These 1,100 returns paid tax on about 32 percent of income after various exclusions and personal deductions. 41

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40 IRC Sec. 1259 prohibits certain hedging transactions, including short sales against the box, forward contracts, and notional principal contracts to preserve gains by treating such actions as a constructive sale of the asset.

41 Senate Report No. 91-552.
Adjusted for inflation, $200,000 in 1964 equates to $1,200,000 in 2000 dollars. Because the AMT has never been adjusted for inflation, many thousands of taxpayers are now considered “wealthy,” including those who exercised ISOs, regardless of their actual income.

The National Taxpayer Advocate has called for the elimination of the AMT for individuals, stating in a report to Congress:

**Problem:** Although originally aimed at the very wealthy, the Alternative Minimum Tax is now affecting a growing number of middle-income taxpayers. Just three years ago, only 600,000 taxpayers were affected by the Alternative Minimum Tax. Over 17 million taxpayers will be subject to the Alternative Minimum Tax by the year 2010. Taxpayers with adjusted gross income of less than $100,000 will owe 60% of the nation’s Alternative Minimum Tax bill by the year 2000.

Taxpayers must make complex and burdensome calculations simply to find out whether they are required to pay Alternative Minimum Tax. Due to the complexities involved, many middle-income taxpayers are not even aware they owe Alternative Minimum Tax until notified by IRS that they have an additional tax liability.

**Recommendations:** Repeal section 55 as to Alternative Minimum Tax for individuals.

If repeal is not enacted, change the requirements as follows:

- Substantially increase the Alternative Minimum Tax exemption amount and provide for future indexing.
- Eliminate the personal and dependency exemptions as adjustments to regular taxable income in arriving at Alternative Minimum Tax.
- Eliminate Schedule A itemized deductions as adjustments to regular taxable income in arriving at Alternative Minimum Tax.  

The AMT should be adjusted to apply only to taxpayers whose AGI exceeds $1.2 million thus, retaining the AMT’s purpose: ensuring the wealthiest pay their fair share of tax. In addition, such a change would eliminate AMT on the exercise of ISOs for all employees except the highest paid management.

### 2.4 Revise IRC Sec. 83(b)

Individuals holding employee stock options should be accorded the same rights as those holding actual stock. Alarmingly, it turns out that in 1976 Congress instructed IRS to draft rules to allow a Section 83(b) election for stock options, as well as stock. The legislative history involving the 1976 change in qualified stock options reads as follows:

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42 Report to Congress by the National Taxpayer Advocate, fiscal year 2001, page 75.
The Congress intends that in applying these rules for the future, the Services will make every reasonable effort to determine the fair market value for an option (i.e., in cases where similar property would be valued for estate tax purposes) where the employee irrevocably elects (by reporting the option as income on his tax return or in some other manner to be specified in regulations) to have the option valued at the time it is granted (particularly in the case of an option granted for a new business venture). The Congress intends that the Service will promulgate regulations and rulings setting forth as specifically as possible the criteria which will be weighed in valuing an option which the employee elects to value at the time it is granted.

Contrary to explicit instructions from Congress, the Service produced regulations that make it virtually impossible for employees to elect IRC Sec. 83(b) treatment for options. Instead of providing a method to value options as Congress stipulated, IRS chose to disqualify virtually all employee stock options from IRC Sec. 83(a), which meant employees could not use IRC Sec. 83(b) to elect immediate taxation.

In general, IRS requires that an option (not the underlying stock) be actively traded on an established market, a constraint that effectively eliminates employee stock options granted in connection with a new business venture, especially if that venture is in the pre-IPO stage. If the option is not publicly traded, it will not qualify under the regulations unless it is transferable and immediately exercisable, which eliminates practically all employee stock options since they are usually exercisable only under a vesting schedule.

Had IRS drafted regulations consistent with Congressional intent, Jeff could have elected to be taxed when he received his ISO based on its fair market value. Generally, the fair market value of a non-public company could approximate the underlying value of the stock, with a small premium for the option privilege.

A reasonable approach would be to value the option at the identical value of the stock, plus 10-20% for the option premium, depending on the length of the option period and the option price per share. In any event, a mathematical formula could be devised to value stock options, permitting employees to elect immediate taxation under IRC Sec. 83(b).

Much of the problem confronting employees who received either statutory or non-statutory options can be traced to IRS’s lack of implementing regulations consistent with Congressional intent. In so doing, IRS prevented employees from electing to be taxed on their options upon receipt.


44 Currently, if an employee receives 1,000 shares of stock valued at $0.10/share, he has $100 in income. If the employee receives an option for 1,000 shares valued at $0.10/share with an option price of $0.10/share, it costs the employee $100 to exercise the option, but he would not have income upon receiving the stock, because there is no spread. If he later sold the stock for $.10/share ($100 amount realized), he’d have no gain because the $100 option price is added to the stock basis. Thus, the fair market value of the option should approximate the value of the underlying stock, $.10/share for Sec. 83(b) purposes, with a small premium.

45 The Black-Scholes method for valuing options could be modified for non-public companies.
Congress could reinstate its intent that non-public stock options should fall under Sec. 83(a) by insisting that IRS set reasonable procedures to determine the fair market value. Access to Sec. 83(a) should not be restricted because the options are not freely transferable or immediately exercisable, because employee stock options rarely meet these tests.

2.5 Eliminate AMT Upon a Disqualifying Disposition.

If eliminating ISOs from the AMT is not politically possible, then the AMT should not apply when an ISO is subject to a disqualifying disposition, either in the year of exercise or the following year. This change will give taxpayers whose stock has nose-dived the opportunity to make a disqualified disposition and pay ordinary income tax on any spread at disposition, rather than an AMT based on an inflated value at the time of exercise.

This simple remedy is consistent with the original Congressional intent. It would also promote equity: When there is a disqualifying disposition, there is no LTCG benefit that justifies the AMT. Because a disqualifying disposition engages the higher ordinary income tax rates (rather than more favorable LTCG rates), there is no benefit in deferring the tax, so imposing the AMT to counteract a deferral benefit is moot.

2.6 Use an Alternative Valuation Mechanism

The valuation of estates offers a paradigm to the ISO tax problem. Generally, an estate is valued at the fair market value on the date of death. However, IRC Sec. 2032(a) allows the executor to elect to value the 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 six months later. According to Bittker and Lokken:

This election was authorized in 1935, in response to the collapse of the stock market during the economic depression in the 1930s, which, in some cases, reduced the value of estates between the date of death and the due date of the return of the estate so drastically that the tax exceeded the value of the estate.\(^\text{46}\)

Estate taxes are based on the accrual of wealth theory, rather than the realization concept: There is a date on which assets are valued (date of death) and recognizing that such an approach can be arbitrary if the value of the estate subsequently tumbles, the tax law permits an alternative valuation date.

The same problem often arises with stock options. When taxes based on the accrual of wealth are calculated on a specific date, the situation requires an alternative date to accommodate a subsequent drop in value. For ISOs and non-quals, the alternative valuation date should be 12 months after the date of exercise or upon the sale of the stock, whichever occurs first.

\(^{46}\) Bittker and Lokken, supra, paragraph 135.7.1:
3 HOW TO REMEDY THE CURRENT AMT DISASTER

3.1 Allow for a Disqualifying Disposition

Congress should consider retroactively eliminating the AMT for individuals or removing ISOs from the AMT calculation to solve the immediate problem affecting thousands of employees.\(^{47}\)

Congress could decide to amend IRC Sec. 55(b)(3) to provide that a disqualifying disposition, regardless of when it occurs, renders the AMT inapplicable, and then permit taxpayers owing AMT to treat the disposition of their ISO stock as a disqualifying disposition. Then taxpayers would pay ordinary income tax on the gain rather than the AMT. If taxpayers are still holding their stock, they should be allowed to dispose of it within three to six months and treat the disposition as a disqualifying disposition.

3.2 How IRS Should Handle the Problem Absent a Legislative Change

If Congress does not enact legislation to deal with the present problem, then IRS should set a policy regarding the collection of the tax due.

3.2.1 NATIONAL TAXPAYER ADVOCATE SHOULD SET A NATIONAL POLICY

The National Taxpayer Advocate should intervene and set a national policy involving collecting an AMT tax liability for stock that is worth, or has been sold for, a fraction of its AMT value. In 1998, Congress expanded how the National Taxpayer Advocate could issue a Taxpayer’s Assistance Order (TAO).

Under the IRS Restructuring Act (P.L. 105-206) which amended §7811, the Taxpayer Advocate may issue a TAO when there is a significant hardship which occurs if: (i) there is an immediate threat of adverse action to the taxpayer; or (ii) the taxpayer will suffer irreparable injury, or long-term adverse impact, if relief is not granted.

Regulation Section 301.7811-1(a)(4)(ii) defines a significant hardship as a serious deprivation caused or about to be caused to the taxpayer as the result of the particular manner in which the tax laws are being administered by the IRS.

In Jeff’s case, his owing $1 million more in taxes than his stock is worth causes him, and possibly thousands of others, serious deprivation. There is also the immediate threat of adverse action as IRS attempts to collect. Taxpayers will suffer irreparable injury as they cannot use bankruptcy\(^{48}\) to discharge these taxes.

\(^{47}\) If this legislation is enacted prospectively, then Congress should provide a remedy for these employees, by allowing a one-time election to treat the disposition of stock as a disqualifying disposition.

\(^{48}\) In general, personal bankruptcy can eliminate tax liabilities that are more than three years old, provided non-fraudulent tax returns have been filed at least two years before declaring bankruptcy. If IRS has assessed additional taxes, there is a 240-day waiting period from the date of assessment.
Also, this situation is a tax-code induced calamity: Thousands of taxpayers received assets that, because of the AMT, contained a hidden risk that no prudent investor would ever accept. These taxpayers lost not only the value of their investments, a risk that all investors take, but they are now slapped with a tax bill that vastly exceeds the value of the original investment. The AMT in this situation, is fundamentally at odds with fairness and equity in the administration of our tax laws. Congress recognized when it drafted the first Taxpayer’s Bill of Rights that because of the complexity of the tax code, there are situations where it would be unjust to administer the law as written – and this is clearly one of those situations.

By pre-tagging these cases and working toward a solution, the National Taxpayer Advocate, on record as favoring the elimination of AMT, could set a policy that prevents serious deprivation caused by our tax laws.

3.2.2 OFFER-IN-COMPROMISE PROCESS

The collection division of IRS, perhaps in conjunction with the National Taxpayer Advocate, could set a national policy for offers-in-compromise arising from the AMT on stock options. 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.

This is undeniably an exceptional circumstance: the unforeseen crash of many New Economy companies whose well-intentioned employees unwittingly exercised risky ISOs and

49 Note the use of the plural “taxpayers” in the phrase “collection of the full liability will be detrimental to voluntary compliance by taxpayers” requires that IRS must take into account voluntary compliance issues with respect to taxpayers in general, rather than just the individual taxpayer whose offer is at issue.

50 The regulation reads:

(4) Promote Effective Tax Administration.
If there are no grounds for compromise under paragraphs (b)(2) and (3) of this temporary regulation, a compromise may be entered into to promote effective tax administration when--

(i) Collection of the full liability will create economic hardship within the meaning of section 301.6343-1; or

(ii) Regardless of the taxpayer's financial circumstances, exceptional circumstances exist such that collection of the full liability will be detrimental to voluntary compliance by taxpayers; and

(iii) Compromise of the liability will not undermine compliance by taxpayers with the tax laws.

(iv) Special Rules For Evaluating Offers To Promote Effective Tax Administration.

(A) The determination to accept or reject an offer to compromise made on the ground that acceptance would promote effective tax administration within the meaning of this section will be based upon consideration of all the facts and circumstances, including the taxpayer's record of overall compliance with the tax laws.
the imposition of the complex AMT rules. Because such a tax is fundamentally inequitable, voluntary compliance by all facing this situation could greatly suffer. Those taxpayers who are not U.S. citizens could leave the country, and continue to earn a substantial living by working remotely (telecommuting from another country). Taxpayers, who are U.S. citizens are faced with financial ruin for the foreseeable future, could also decide to leave the country or may drop out of the tax system.

Currently, there is no reporting requirement for ISOs so unless IRS manually audits the company or each individual taxpayer, it will not discover the issue. IRS’s increasing reliance on computer-matching as an audit technique will not work in this instance. Also, the role of tax preparers and accountants as “watch-dogs” of the system is eroding because taxpayers who decide not to report their ISO exercise may by-pass those professionals and file their taxes directly on-line. There is little chance those who “forgot” to report their ISO exercise will get caught, and if they do, they can always blame the software accounting package or their tax preparer for not catching the mistake.\footnote{51}

\subsection*{3.3 Use the AMT Credit to Offset the AMT Liability}

Another problem with the AMT is that the taxpayer pays the AMT, but cannot immediately use the AMT credit, which arises when the stock is sold. Use of the credit is dribbled out over many years, under another set of confusing rules. Logically, the taxpayer should be able to use the AMT credit to off-set the original AMT liability. If the taxpayer has an AMT liability of $1,000,000 and a credit of $900,000, the entire credit should off-set the tax. IRS should allow AMT credit to offset AMT liability first.\footnote{52}

Currently, as part of the offer-in-compromise process, IRS may require the taxpayer to reduce his basis of assets on the theory that the taxpayer should not retain a future tax benefit from property excluded from the determination of the offer amount. A reduction in basis means the taxpayer will pay tax on the asset when sold, thereby deferring that tax until the time of sale.\footnote{53}

Conversely, if the taxpayer has a future credit to offset regular taxes, the taxpayer should be able to treat the credit as an asset for offer-in-compromise purposes on the flip-side of the same theory. Under the offer-in-compromise process, the Collateral Agreement (Form 2261-C, revised 5-88) allows the use of net operating losses, net capital losses and unused investment credits to off-set taxes, treating them as “additional amounts of taxes paid.” Paragraph 4 of the Collateral Agreement states:

That the aggregate amount paid under the terms of the offer in compromise and the additional amounts of taxes paid as the result of the waiver of the losses and

\footnote{51} There are plenty of tax scam promoters on the web encouraging tax evasion through phony trusts and other devices who would gladly “de-tax” these affected individuals and make them invisible to IRS. See Senate Finance hearing testimony April 5, 2001 involving the proliferation of tax fraud schemes on the web. (http://www.deathandtaxes.com/senate_finance_hearing.htm). Recently, these promoters have been targeting those with tax liabilities arising from the exercise of employee stock options.

\footnote{52} The Secretary of the Treasury, under IRS Sec. 59(g) (the tax benefit rule), should have the discretion to allow the AMT credit to directly off-set the AMT liability arising from the sale of the same asset when there will be no reduction in the taxpayer’s regular income.

\footnote{53} See the Internal Revenue Manual (IRM) [5.8]6.3 (2-4-00).
credits involved in this agreement shall not exceed an amount equivalent to the liability covered by the offer plus statutory additions that would become due in the absence of the compromise. [emphasis added]

IRS should not require a taxpayer to liquidate property to pay a tax for which there is an off-setting credit.

4 CONCLUSION

The AMT wrecking ball is smashing through our high-tech sectors with its indiscriminate application to ISOs and causing wide-spread devastation to those who exercised their options, and who also had to watch their stock collapse as they worked for the long-term prospects of their company. This was not how either the AMT or ISOs were supposed to work. Congress intended that if a taxpayer sold the stock within 12 months of exercise (or within 2 years of grant), the transaction would be taxed as ordinary income and the AMT would not apply. Had the Congressional mandate been incorporated into law, many employees would not be burdened by the AMT that overwhelms their current stock investment.

Taxing the spread upon exercise turns workers who are receiving compensation for services into short-term stock speculators, most without the sophistication necessary to manage highly risky investments.

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

Had IRS drafted regulations consistent with legislative intent in IRC Sec. 83 and allowed employees to elect immediate taxation on the receipt of options, the agony felt by those holding ISOs and non-quals could have been greatly reduced, if not eliminated, since an election to be taxed immediately on such investments would have produced little or no tax. Once again, employees holding company stock options were victimized by the failure to implement laws that would have protected them in precisely this situation.

Congress can still implement those very changes they recommended with respect to the AMT and IRC Sec. 83. In addition, because of complexities and unexpected results from the current AMT laws, the AMT should not apply to ISOs, at least for those with adjusted gross incomes of less than $1,200,000.

If Congress will not provide legislative relief, IRS can address the situation either through the National Taxpayer’s Advocate’s office or within the offer-in-compromise process. There is regulatory direction for IRS not to collect every last dime owed by taxpayers when to do so will create a significant hardship. The offer-in-compromise process permits a solution when equity and public policy are involved. Such a remedy might allow the AMT credit to offset AMT liability, which will eliminate, in many cases, the unjust tax problem plaguing Jeff and many of his colleagues.