

- Testimony of Betty M. Wilson, president, **Tax Executives Institute**. *Doc 2001-11941 (6 original pages); 2001 TNT 82-58*
- **AICPA** release. *Doc 2001-11942 (2 original pages); 2001 TNT 82-59*
- **ABA Section of Taxation** letter to William V. Roth Jr., former chair, Finance Committee. *Doc 2000-5609 (3 original pages); 2000 TNT 39-73*

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Tax Analysts

Outdated AMT Claims First Victims of the 21st Century

By Warran Rojas — warrenr@tax.org

A number of taxpayers who exercised incentive stock options (ISOs) last year, and received a rude awakening this filing season because of their alternative minimum tax liability, have cried foul because they claim they never had — and now may never have — enough wealth to cover their tax bills.

While Capitol Hill has been awash with talk of President Bush's \$1.6 trillion tax cut (see story on p. 695.) Rep. Zoe Lofgren, D-Calif., has taken up the cause of a slew of high-tech employees blindsided by overwhelming tax bills caused by the current stock market plunge. Lofgren has introduced a new bill to deal with the problematic AMT.

The Lofgren bill, H.R. 1487, would eliminate ISOs from AMT consideration by modifying current law so taxes apply only at the point of sale, rather than at the point of exercise of a stock option. The change, retroactive to 2000, would let those taxpayers caught off-guard by the recent economic downturn off the hook. No cost estimates are available for the bill because the Joint Committee on Taxation has not yet scored it.

"My constituents are a lot more interested in this bill than they are in marginal tax relief for people in the top 1 percent income bracket," Lofgren said. "And that's where the real cost is in the Bush plan."

'My constituents are a lot more interested in this bill than they are in marginal tax relief for people in the top 1 percent income bracket,' Lofgren said.

Democrats insist that the administration's tax plan provides most of its benefits to the wealthiest taxpayers, while simultaneously jeopardizing the economic future of the middle class by refusing to adjust the AMT.

The bill is currently co-sponsored by several California Democrats including House taxwriter Robert T. Matsui, but Lofgren plans on circulating a "Dear Colleague" letter to fellow Californian and Ways and Means Chair William M. Thomas and other Republicans in the next few weeks in the hopes of picking up more support for the initiative.

The bill already has some bipartisan support. House Republicans Thomas M. Davis from Vir-

ginia, Christopher Cox from California, and Darrell E. Issa from California have signed on as co-sponsors.

According to a Lofgren aide, there is a lot of pressure building behind this issue, and members from both parties are starting to pay close attention. “Anywhere there is a high-tech concentration, this is a problem,” the aide said.

Meanwhile, a group of self-proclaimed “political neophytes” has been galvanized into action because of the AMT. Jeff Chou, a former employee of computer giant Cisco Systems and one of the taxpayers getting pinched by the AMT, is heading up the grassroots movement calling for support of H.R. 1487 and immediate AMT reform.

Chou maintains that he is facing the loss of everything he has ever worked for and, on top of that, he can look forward to a monthly bill from the IRS on a debt he will never be able to retire. “If I don’t do this and I don’t get any relief, my life is ruined,” he said.

An Unforeseen Pitfall

The core of this latest AMT snag lies in the treatment of incentive stock options by the tax code. While many people remain in the regular income tax system and do not yet have to deal with the parallel AMT, a growing number of taxpayers are finding themselves caught for one reason or another in the AMT’s net. That number is expected to soar over the next decade.

The primary cause of the problem is that while incomes continue to rise, the AMT system is not indexed for inflation. So an increasing number of middle-income taxpayers are falling into a trap originally designed for the rich who were using planning techniques — many of which are no longer available — to shelter income.

When an employee exercises options, a tax debt can be produced even though the employee has sold no stock or acquired any ‘real’ money.

Under current law, employees do not recognize any taxable income when they exercise their ISOs, with income recognition being deferred until the stock is sold. To qualify for these stock options, most employees are required to hold the stock for two years after grant and one year after exercise; if they don’t, they face regular income tax liability.

While the regular tax system lies dormant, the AMT snaps to attention the moment stock options are exercised. The “spread income” — which is calculated by taking the difference between the exercise price and the fair market value

of the stock at the time of exercise — is alternative minimum taxable income. So when an employee exercises options, a tax debt can be produced even though the employee has sold no stock or acquired any “real” money, just the paper gain.

Meanwhile, as the stock market has tumbled, ISO stockholders have watched their portfolios dwindle away, while their AMT debt has held steady.

Stepping Up to Bat

In an April 16 letter to IRS Commissioner Charles O. Rossotti, Lofgren asked the IRS for help for stockholders unaware of the AMT, noting that lawmakers have yet to provide them with any relief.

“Unfortunately, the current tax debate in Congress is not focused on emerging tax issues in the new economy,” she said, adding, “This is not a question of greed punished, but rather of hard work gone unrewarded.”

Lofgren indicated that she had spoken with leaders from both parties but decided to move forward with her own bill rather than waiting for somebody else to take the initiative.

“The Republican [leaders] didn’t say ‘no,’ but they didn’t also include it in anything,” she said.

Matsui said this was just another glimpse of the “sleeping giant” that is the AMT. He noted that many tech workers had told him they were taking out first and second mortgages on their homes just to cover their tax bills because they were basically cash poor. “Now that the value of their stock options is almost nothing, they are still expected to pay taxes on phantom profits,” he said.

According to Matsui, during the two-week Easter recess, constituents in his district brought up the issue of ISOs and the AMT just as much as they brought up the American captives in China. He stipulated that many of those affected were middle-class employees who faithfully invested in their own companies, only to see the tax code punish them.

“They’re not the millionaires,” he said. “That’s why this thing has taken on a life of its own.”

Matsui said that while the House has already moved four main tax bills — the doubling of the child credit to \$1,000 and repeal of the so-called marriage penalty, repeal of the estate tax, the retroactive reduction in marginal tax rates, and a pension reform package (see p. 699) — which cover most of the president’s tax proposals, he was still hopeful AMT reform might see some action this year.

Lawmakers and staffers in both chambers have suggested there could be a fifth tax bill — tying

an increase in the minimum wage to small business tax breaks or additional tax initiatives — in the works.

If the opportunity presented itself, Matsui said he would look to push H.R. 1487, citing any potential tax bills or even the comprehensive House reconciliation tax bill as a possible target vehicle.

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“My guess is that if we find a vehicle, we will try to do it, because this has to be dealt with,” he said. “My hope is that we can deal generally with the AMT, otherwise the president’s tax plan will give tax relief with one hand and snatch it back with another.”

According to Matsui, even if the House were unable to move on AMT reform, there was still a strong chance Senate lawmakers might take up the issue, particularly since he anticipates no shortage of taxpayer outcry on the AMT.

“This issue will continue to build momentum,” he predicted. “A lot of people weren’t even aware of this until they filed their taxes this year.”

A spokesman for Ways and Means ranking Democrat Charles B. Rangel of New York said Rangel would likely support H.R. 1487. According to the Rangel aide, Democrats are deeply concerned about the fact that the AMT has overstepped its original bounds and is steadily encroaching on ordinary, middle-income taxpayers.

The aide noted that while House Republicans have included minor AMT fixes in some of their preliminary tax bills, there has been no major push for complete AMT reform or repeal.

A Republican Ways and Means aide said Thomas knew about H.R. 1487 but that he currently had his hands full with the various components of the Bush tax cut. “This is an issue that has some buzz and we are aware of that,” the aide said. “But the president’s tax plan takes priority.”

Administration officials including Bush economic adviser Lawrence B. Lindsey and Treasury Secretary Paul H. O’Neill have repeatedly stated that AMT reform was primarily a congressional problem and would likely not be addressed by Bush.

A Call to Arms

So in an effort to bring the issue to the forefront, Chou began reformamt.org, a Web site discussion group for victims of the ISO-AMT in-

teraction. The group is planning to hold a major press conference by the beginning of June, and has set up committees to work on congressional letter-writing campaigns, developing alternative tax strategies and solutions, and forming alliances with other tax organizations and companies that might share their concerns.

Members held their first organizational meeting April 24, with approximately 50 participants showing up or joining in via a nationwide conference call. According to Chou, each of the 50 knows at least 5 to 10 other people stuck in the same situation.

According to Chou, the big tasks for the group will be: (1) educating people on the ISO-AMT issue by dispelling the myth that this is a movement of “whinny-crybaby-dotcomers” who don’t want to pay their tax bills, and (2) banishing the shame associated with total indebtedness so more people will step forward and get involved.

Chou says the group has received a great deal of hate mail from those who believe it is a movement of rich dotcomers who gambled in the stock market and lost and now are looking for a way to dodge the tax bullet.

Chou says the group has received a great deal of hate mail from those who believe it is a movement of rich dotcomers who gambled in the stock market and lost.

“We don’t want preferential treatment,” he asserted. “We want to be treated just like every other investor and get taxed when we sell our stocks and realize gains on our equity, not when we purchase them.”

The group is also looking to expand its outreach, although Chou believes that many people are too ashamed to speak out because they consider their financial ruin to be incredibly embarrassing and private.

He described several individuals who have been leveled by their tax debt, including a woman who has become increasingly ill because of her pending bankruptcy, and at least one individual who fled the country rather than settle with the IRS.

A Recipe for Disaster

Chou said he received his ISOs for “pennies on the dollar” and exercised about 100,000 in options in late 2000 when the stock was at about \$65 a share, thereby activating an immediate AMT liability on about \$6.8 million. He subsequently

decided to hold onto his stocks to claim the long-term capital gains in 2001.

As the stock market tumbled, Chou found the value of his stocks slashed by more than half, ultimately settling at their current \$15 a share level. Come April, Chou said he was hit with a \$2.5 million combined state and federal tax bill and no feasible way to pay it. Liquidating all of his stock would still leave him \$1 million in the hole, and even selling off or liquidating all his material possessions (house, car, 401(k) account, etc.) would probably only whittle down his tax debt to a still overwhelming \$500,000.

According to Chou, he is getting taxed on an unrealistic gain, even though he never actually sold any of his stock. He admits that if he had sold before the end of 2000 he could have claimed a disqualifying disposition and avoided the AMT altogether, but that he wanted to hold onto his stock because he loved and trusted in Cisco.

Chou equates the entire ordeal with being taxed 1,000 percent because the IRS is set to take 100 percent of his assets, plus anything he might ever make in his lifetime.

Robert Sommers, tax attorney for Chou and others like him, said he is working with the group to try and quantify the AMT problem so they can show Congress how widespread a problem it has become. He noted that many of his clients, in their quest to enjoy the preferential long-term capital gains rates afforded those who hold their stocks for a year after exercising their options, watched in horror as the market collapsed.

Sommers said stock options are in today's business world, with many employers passing out options in lieu of pay. According to Sommers, the current situation followed an almost textbook recipe: Add one plummeting stock market, mix in an archaic, overbroad tax provision, and season lightly with countless employees holding volatile stock options as a compensation substitute and you produce a perfect tax disaster.

Acknowledging the inherent difficulty of navigating the "uncharted waters" of the AMT and new economy, Sommers said that this could be the first time in history that by holding an asset, you might owe more in taxes than your entire net worth. He said many taxpayers were basically facing tax bills assessed on real gold, while they were left holding only fool's gold. "It's based on a wildly fictitious value," he asserted.

According to Sommers, the AMT had long ago graduated from isolated tax issue to the point where it is now hitting progressive industries like computer and Internet technologies. He said the outdated AMT was now butting heads with the changing world of employee compensation, and

that unless it was corrected soon, the business world would suffer. "If this is the policy, then stock options are dead," he said. "Who would want them?"

Rather than keeping the wealthy in check, Sommers said, the AMT was now assuring that hard-working Americans would shy away from exploring innovative new careers or business opportunities because the tax risks outweigh the potential benefits.

Sommers said the AMT was single-handedly breaking the American spirit — a feat no foreign nation has been able to accomplish — by ensuring that the best and brightest minds in America work hard and remain flat broke. "The AMT is destabilizing our country from within," he charged.

Sommers said the AMT was single-handedly breaking the American spirit — a feat no foreign nation has been able to accomplish.

Richard Halberstein, another member of the group, had a similar tale of woe. He said he received his options to buy stock at under \$2 a share, and chose to exercise options on about 7,500 shares in the start-up he worked for when the stock hit \$16 a share. Then the bottom dropped out. His combined tax bill came out to more than \$60,000 for 2000 — a figure he says is more than his annual income — with approximately \$40,000 in AMT liability and another \$20,000 from capital gains.

Halberstein said he sold off approximately 3,000 shares when the stock price rose to \$6 just so he could hand the IRS something, but noted that even if he dumped the remainder of his stock, he could still pay only half his tax bill.

Halberstein said he understood some of the criticisms being heaped on the group because some people had in fact mismanaged their finances. He maintained that the more compelling issue, however, was that the AMT had never been indexed for inflation, so more and more people will continue to get wrapped in its tendrils as time goes by.

"In 50 years, everyone will pay AMT," he predicted. "It's going to cut the legs out from under our economy."

According to Chou, he could have taken the easy way out by simply not reporting to the IRS — as he believes some technology employees may have chosen to do — because they have no real way of monitoring when people exercise their options. He did so voluntarily, however, be-

cause he said he has always been a hard-working taxpayer and did not wish to cheat the government in anyway.

"I have faith in this country that it will not punish those of us who have honestly reported our taxes," he said. ■

Full Text Citations

- Text of **H.R. 1487**. *Doc 2001-12026 (2 original pages)*
- Release by Rep. Zoe **Lofgren**, D-Calif., on introduction of H.R. 1487. *Doc 2001-12027 (2 original pages)*
- Letter to IRS Commissioner Charles O. **Rossotti**. *Doc 2001-12112 (1 original page)*

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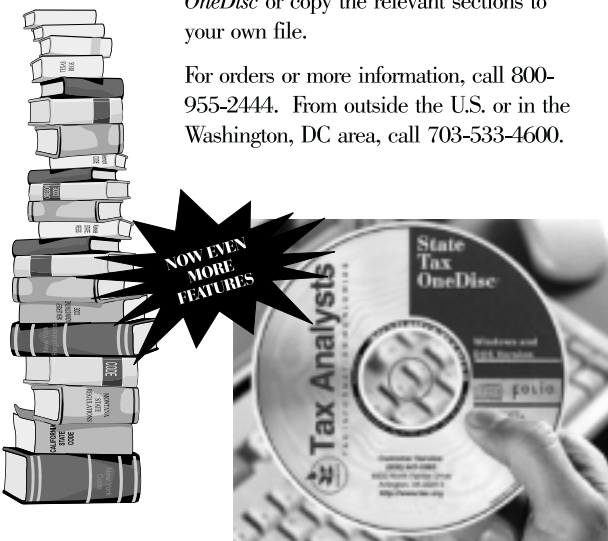
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Bush Ready to Compromise As Budget Conference Begins

By Patti Mohr — patriciam@tax.org
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Budget conferees from both chambers met last week to begin smoothing out differences between the House and Senate budget resolutions and their tax cut numbers, with President Bush declaring late in the week that he was willing to negotiate on a tax cut smaller than \$1.6 trillion.

Bush and Republican congressional leaders conceded that they did not have the votes in the evenly split Senate to push through the president's entire \$1.6 trillion, 10-year tax cut.

Bush told various media outlets that he believed his tax cut would have to be reduced from his original \$1.6 trillion figure before it could pass the House and Senate. "I'm a practical man. I want to get it done," he said. "We're now down to counting votes."

'I'm a practical man. I want to get it done,' Bush said. 'We're now down to counting votes.'

Fresh off a two-week Easter break, Democrats and key Republican moderates stepped back into the thick of the budget melee by touting the Senate's \$1.2 trillion tax cut as the ceiling for tax cuts, effectively forcing the administration to come down on its own number. While the House-passed budget comfortably accommodates Bush's full tax cut, the Senate reported out a budget resolution with a reduced \$1.2 trillion figure, an \$85 billion stimulus package for 2001, and additional funds for priority spending initiatives and payments on the debt.

Senate Republicans said they hope to complete work on the budget quickly so they can move forward on the various House-passed tax bills by Memorial Day weekend. Democrats, however, maintain the administration and the GOP leaders on Capitol Hill have left no real room for negotiation.

Fishing for Votes

The pressure was on last week as the White House attempted to test the resolve of Senate moderates and tried to persuade them to agree to as big a tax cut as possible.

At press time, the centrists most responsible for the current \$1.2 trillion tax number, Senate Budget Committee and Finance Committee member John B. Breaux, D-La., Sens. Lincoln D.