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By Mr. LIEBERMAN:

S. 1324. A bill to provide relief from the alternative minimum tax with respect to incentive stock options exercised during 2000; to the Committee on Finance.

Mr. LIEBERMAN. Madam President, today I am introducing a second proposal with regard to the perverse impact of the Alternative Minimum Tax, AMT, on Incentive Stock Options, ISOs. I previously introduced a bill, S. 1142, addressing this issue going forward and today I am introducing a bill to provide relief to the victims of this perverse tax who filed returns and paid taxes this past April. As I will explain, they were hit by the tax equivalent of the perfect storm.

The argument for reform of the AMT as applied to ISOs is overwhelming. An employee who receives ISOs is taxed on the phantom paper gains the tax code deems to exist when he or she exercises an option, and is required to pay the AMT tax on these "gains" even if the "gains" do not, in fact, exist. This means the taxpayer may have no gains, no profits or assets, with which to pay the AMT and might even have to borrow funds to pay the tax, go into default on his or her AMT liability, or even declare bankruptcy.

This Kafkaesque situation is unfair. It is not fair to impose tax on "income" or "gains" unless the income or gains exist. With the AMT tax on ISOs, it is not relevant if the "gains" exist in a financial sense. That they exist on paper is sufficient to trigger the tax.

In terms of providing relief to taxpayers hit with the AMT on ISOs in their filing for 2000 taxes, let me make a series of points.

First, there have been victims of the AMT/ISO tax going back before 2000. But, there were an unprecedented number of victims this last year due to a convergence of events.

Over the last decade, more and more companies have adopted broad-based stock option plans where all or almost all employees are granted ISOs, rather than only senior management.

In addition, the internet and telecommunications boom spawned an unprecedented number of start-up companies over the last few years.

These start-ups overwhelmingly favor the use of ISOs as a means of attracting and motivating employees, and many of these companies grant options to most, if not all of their employees.

Then, as we all know, the stock market, especially the technology-driven NASDAQ, posted record highs in the spring of 2000, and then collapsed over the next 12 months, astounding even seasoned professionals. Many of the high-flying technology companies saw their stock value drop 80 percent to 90 percent during this period.

As a result, the relatively unknown AMT caught many employees by surprise. Other employees were aware of the AMT but thought they could claim a full credit for the AMT once they sold the stock acquired by exercise of ISOs. Some were unable to sell before year-end, in order to eliminate the AMT hit, by trading restrictions. Others were naive in thinking that the value of the shares they held would rebound in 2001, in time to sell the stock and pay their AMT liability for 2000.

In short, in tax year 2000 we saw the tax equivalent of the perfect storm.

Second, the imposition of AMT on individuals discourages the very behavior that Congress wanted to encourage with the creation of ISOs. In 1984, the

Senate Finance Committee noted the goal of ISOs to "encourage employee ownership of the stock on an employer's business" by allowing for "the deferral of tax until an employee disposes of the stock received through the exercise of an employee stock option". To encourage individuals to hold shares with the promise of capital gains tax rates is the goal, but it is a goal that is defeated when the AMT is imposed at the time they exercise an option even if the "gains" are never realized. The taxpayers who held their shares and realized gain are the ones who deserve relief. They fell into a trap which the tax code created through its perverse and confusing structure.

Third, the trap was one that many of these employees did not understand. They rightly assumed that the AMT was directed at taxing the wealthy and could not possibly affect them. This is a case where the complexity of the tax and the contradictory incentives it provides for ISOs lured the victims into the trap.

Fourth, we are likely to see a major debate on AMT reform, but this is a broader debate about the fundamentals of the tax code, not a tax trap like we have with ISOs. An increasing number of taxpayers find themselves paying the AMT because they have large state tax deductions or large numbers of personal exemptions. The AMT is likely to snare 1.5 million taxpayers this year and nearly 36 million by 2010. The AMT they may pay may be infuriating, but it would normally not substantially increase their overall tax liability. The AMT paid because of ISOs can be hundreds of thousands or even millions of dollars and can be devastating. It can cause a tax liability that is many times the taxpayer's total income. This is a problem that needs to be addressed not, now when we finally take up broad-based AMT reform.

Let me be clear about the cost and budget implications of my bill. The Joint Tax Committee on Taxation has found that my proposal would reduce government tax revenues by \$1.3 billion over ten years. This is substantially less expensive than the cost of my earlier bill, which was estimated to cost \$12.412 billion over

ten years. I will not propose to enact my bill unless this sum is financed and will have no impact on the Federal budget.

The budget situation we face will not make it easy to enact these reforms. The massive tax cut of \$1.3 trillion was financed from the surpluses. We are now finding that it was, as I and others feared, way too large and leaves us no room to take up additional tax measures. In fact, just last week we saw reports of a memo leaked where

Republicans predicting that the Congressional Budget Office deficit/budget updates in August would find that we have zero available surplus beyond the Social Security and Medicare trust funds in fiscal year 2002 and that Congress may have to dip into those trust funds by nearly \$41 billion in fiscal year 2003. If this is true, it would leave no additional non-trust fund surplus dollars available for other uses, such as growth tax incentives, fixing the ISO/AMT problem, education, energy or defense, in fiscal year 2002. The fiscal year 2002 budget resolution bars Congress from spending any money in either the Social Security or Medicare Part A trust funds for any purpose other than Medicare or Social Security.

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I recount this here because it means that we must find a revenue or spending offset to finance our ISO/AMT proposal, or any other growth tax incentive. We cannot use the surplus. This raises a substantial barrier to enactment of this proposal and it is a barrier that we could have easily avoided had we enacted a tax cut we could afford.

I am pleased that today Rep. **RICHARD NEAL, TOM DAVIS, ZOE LOFGREN,** and **JERRY WELLER** are introducing the same bill in the other body. Earlier, Representative **LOFGREN** introduced **H.R. 1487**, a bipartisan bill that has given a great deal of visibility to this issue. I look forward to working with my distinguished House colleagues to remedy this inequity in the tax code, both for victims in 2000 and going forward.

Finally, let me note that I have proposed in S. 1134 to provide a special capital gains tax rate, in fact to set a zero tax rate, for stock purchased by employees in stock option plans, by investors in Initial Public Offerings, and similar purchases of company treasury stock. This zero rate would be effective, however, only if the shares are held for at least three years, so the AMT gamble with ISOs would be even more dramatic. During the first year of that holding period, the AMT would have to be paid and during the remaining period the value of the stock could well dive from the exercise price creating an even more invidious trap.

We need to fix the ISO/AMT problem so that capital gains incentives for entrepreneurs will work as intended and provide the boost to economic growth.

We need also to focus on the victims of the 2000 perfect storm.

I ask that two documents be printed at this point in the **RECORD**, an explanation of my bill and a comparison of incentive and nonstatutory stock options. Both have been prepared by professionals with accounting firms.

Incentive Stock Options and the Alternative Minimum Tax--An Explanation of the Lieberman-Neal-Davis-Lofgren-Weller Proposal

Issue: The difference between the exercise price and the fair market value at the time of exercise, the "spread", of stock obtained with an incentive stock option, "ISO", is a tax preference for purposes of the individual alternative minimum tax, "AMT". If the ISO preference causes a taxpayer to pay the AMT for the year of exercise, there may be a tax credit carryforward that is available to offset regular tax in a future year. However, if the stock declines significantly in value between the date of exercise and the date of its sale, there may not be sufficient regular income in any future year to utilize the AMT credit. As a result, a taxpayer may pay significant permanent AMT for what was intended to be only a "timing" preference. This problem is particularly acute for individuals who exercised incentive stock options in 2000, prior to the significant decline in the stock values of many companies.

Example: In January, 2000, a sales manager for Silicon Valley Company exercises options for 15,000 shares of stock with an exercise price of \$5 per

share, the fair market of the stock when the options were granted in 1997. At the date of exercise, the stock is trading at \$125 per share. The spread gives rise to an AMT tax preference of \$1.8 million and generates a net AMT liability for 2000 of approximately \$500,000.00, over and above the manager's tax liability on her \$60,000 annual salary. Since ISO stock retained for at least a year from the date of exercise is eligible for capital gains treatment, manager does not immediately sell her ISO shares. In April 2001, the company and the stock market have setbacks and the stock again trades at \$5 per share.

Under current law, the amount of AMT credit that the manager can use annually is limited to approximately \$5,000, her expected regular tax over her AMT tax. As a result, it would take roughly 100 years for the AMT credits to be fully utilized.

Lieberman/Neal/Davis/Lofgren/Weller Proposal: Limits the amount of the AMT preference resulting from the exercise of an incentive stock option in 2000 to an amount based on the fair market value of the stock as of April 15, 2001, or, if such stock is sold or exchanged on or before that date, to the amount realized on such sale or exchange.

Example: Under the same facts as above, a sales manager who acquired stock through the exercise of an incentive stock option would use the \$5 per share April 15, 2001 fair market value of the stock to calculate the AMT preference amount. If the manager has already filed her 2000 tax return, she would file an amended return for the 2000 tax year to reflect the revised AMT preference amount of \$0.00, the revised April 15, 2001 fair market value of \$5.00 per share equals the original \$5.00 per share exercise price.

COMPARISON OF INCENTIVE AND NONSTATUTORY STOCK OPTIONS

The following is a broad overview of the basic tax concepts that apply to U.S. taxpayers who receive stock options granted by U.S. companies, for services rendered. It does not address the tax consequences for non-U.S. taxpayers or the company issuing the options. This outline assumes that the stock received upon exercise is not restricted within the meaning of IRC section 83. If there are

restrictions on the stock received upon exercise, the tax consequences will differ significantly from that described in this outline.

TERMS

Grant Date--This is the date the stock options are granted to you by the company. This date generally is reset if the terms of the stock option are changed; e.g. exercise price is lowered.

Exercise Price--This is the price you have to pay to purchase a share of stock under the terms of the option agreement.

Vesting Date--This is the date that you earn the right to exercise your options. For example, your shares may vest over four years, starting after one year. In this case, on each anniversary of the grant date you earn the right to exercise one fourth of your options.

Exercise Date--This is the day you exercise your stock options by paying the exercise price to purchase the shares in which you are vested.

Fair Market Value--This is the true value of the stock at any given date, usually determined by the price at which the stock is trading for on an established exchange. For a private company, the fair market value should be determined by an independent third party appraisal. If the company does not have an outside appraisal performed, the Board should establish the value using appropriate methods and current information.

Spread on Exercise Date--This is the difference between the exercise price (what you pay for the stock) and the fair market value (what the stock is worth) at the time you exercise your stock options. This is often referred to as the bargain element.

Sale Date--This is the day you sell the shares of stock you had previously purchased on the exercise date.

Spread on Sale Date--This is the difference between the exercise price (what you paid for the stock) and the fair market value (what the stock is worth) on the day you sell your shares.

Incentive Stock Options (ISOs)--These are stock options that qualify for special tax treatment by meeting a number of special rules, the details of which are not included in this memo. One of the key requirements is that the exercise price is at least equal to the fair market value at the date of grant. ISOs are contrasted with Nonstatutory Stock Options in the following table.

Nonstatutory Stock Options (NSOs; also referred to as NQOs, as in nonqualified)--These are stock options that do not meet all the rules for ISOs. They are less tax favored, but generally more flexible.

COMPARISON OF TAX CONSEQUENCES--INCENTIVE STOCK OPTION VS. NONSTATUTORY STOCK OPTIONS		
Event	Incentive stock options	Nonstatutory stock options
Grant Date: For example, you are granted the right to purchase 1,000 shares at \$1.50 per share vesting over 4 years	The grant of an incentive stock option is not a taxable event	The grant of a nonstatutory stock option is almost always not a taxable event. For this comparison, we'll assume it is not a taxable event.
Vesting Date: For example, after one year you have the right to purchase 250 shares	Vesting is not a taxable event	Vesting is not a taxable event.
Exercise Date: For example, you pay \$1,500 and purchase all 1,000 shares when they are worth \$13.50 each, i.e. \$13,500 for a spread of \$12,000. (This discussion assumes the shares received upon exercise are not restricted under tax law)	ISOs: The exercise of ISOs is not a taxable event for regular tax. However, the spread or bargain element is a tax preference item for the alternative minimum tax (AMT), unless you exercise and sell your ISO stock within the same year, in which case AMT does not apply	NSOs: The spread at exercise (\$12 per share) is compensation income, reportable on your W-2 and subject to income and payroll tax withholding. You get tax basis in the stock equal to the Fair Market Value on the exercise date, i.e. \$13.50 per share. AMT does not apply to NSOs.
Sale Date: For example, you hold the shares for a while and then sell them for \$15.00 each;	If you meet the holding rules below, the entire spread (\$13,500) on the date of sale is taxed as a capital gain.	The difference between the sale price, i.e. \$15.00 and tax basis of \$13.50 is a capital gain. (You already paid tax on the \$12 per

<p>i.e. you sell the stock for \$15,000 that had cost \$1,500, for a gain of \$13,500</p>	<p>Regardless of how long you hold the stock, you get a credit for any alternative minimum tax you may have paid upon exercise, but you may not be able to use it all in any given year</p>	<p>share spread at exercise.) For sales after 12/31/97, you must hold the shares for more than one year to get long term capital gain treatment. You could also have loss, if so, it would be a capital loss.</p>
<p>Special ISO Holding Rule</p>	<p>You must hold your ISO shares for more than one year from the date of exercise and two years from the grant date before you sell them; in order to have the entire spread taxed as a capital gain. Meeting these holding periods converts the spread (i.e. the bargain element on the date of exercise) from ordinary income to long term capital gains, taxed at a lower rate</p>	<p>An earlier sale turns the tax treatment of an ISO into that of an NSO. The spread on exercise date (or the spread on sale, if less) is taxed as compensation, reportable on your W-2, but only in the year of sale. If the sale occurs in a year after the year of exercise, you still are subject to alternative minimum tax in the year of exercise (based on the spread at exercise).</p>