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ESSAY

INCENTIVE STOCK OPTIONS AND THE ALTERNATIVE MINIMUM TAX: THE WORST OF TIMES

FRANCINE J. LIPMAN*

Congress enacted the Alternative Minimum Tax ("AMT") to stop high-income individuals from escaping their tax liabilities through tax code loopholes. In recent years, increasing numbers of moderate-income taxpayers have been subject to astronomical AMT liabilities. The problem has been especially acute for technology sector employees who exercised stock options while the market was high, sold their stock after its value fell, and found themselves owing AMT they could not afford to pay. In this Essay, Professor Lipman explains the Internal Revenue Code's complicated treatment of Incentive Stock Options ("ISOs"). She argues that the AMT adjustment for ISOs should not be eliminated, but suggests several reforms to simplify tax treatment of ISOs and reduce the number of taxpayers who are subject to AMT.

I. INTRODUCTION

A. "The Best of Times"

The 1990s were the decade of employee stock options.¹ Employees from the Silicon Valley to high-tech areas along the East Coast demanded and negotiated compensation packages that included grants of stock options. As the stock market continued to soar into record territory through

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¹ The number of employees actually receiving stock options increased from less than one million at the beginning of the 1990s to about ten million by the end of the decade. Corey Rosen, *Five Common Myths About Stock Options*, Feb. 2002, at http://www.nceo.org/library/option_myths.html (last visited Mar. 20, 2002); see also Liz Pulliam Weston, *Stock Options Add Tax Wrinkle for Many 'Dot-Com' Employees*, L.A. TIMES, Dec. 22, 2000, at C1 (citing National Center for Employee Ownership statistics demonstrating that the number of American workers eligible to receive stock options increased from 2.5 million in 1992 to 14.0 million in 1999). More than ten million employees in America own stock options today with an estimated value of between \$500 billion and \$1.2 trillion. Jennifer Nelson, *Opting In*, BLOOMBERG NEWS, Aug. 13, 2001, available at LEXIS, News Library, Bloomberg File; see also David M. Schizer, *Executives and Hedging: The Fragile Legal Foundation of Incentive Compatibility*, 100 COLUM. L. REV. 440, 442 (2000) (citing John Helyar & Joann S. Lublin, *Corporate Coffers Gush With Currency of an Opulent Age*, WALL ST. J., Aug. 10, 1998, at B1).

the spring of 2000,² everyone wanted a piece of the growing stock-market pie.³ Stories about overnight millionaires among the ranks of youthful and enthusiastic “dot.comers” made headlines in newspapers, magazines, and on the Internet.⁴ Employees and independent contractors, including lawyers and accountants, increasingly sought equity interests in employers or clients in lieu of cash compensation.⁵ More and more companies adopted broad-based stock option plans and granted stock options to all levels of employees.⁶ Employees desiring to minimize their tax costs preferred tax-favored incentive stock options (“ISOs”).⁷ In response, numerous corporations created ISO plans and granted their employees ISOs as part of their compensation packages.⁸

² See Tom Petrino, *For Nasdaq, A Bittersweet Anniversary; Two Years After Reaching Its Peak, The Market is Rallying, But Will Investors Ever See 5,000 Again?*, L.A. TIMES, Mar. 10, 2002, at Bus.1 (stating that the Dow index set a record high of 11,722 in January 2000 and the Nasdaq index set a record high of 5049 in March 2000).

³ See *Personal Wealth: Money Isn't Everything in Salary Negotiations*, BLOOMBERG NEWS, Feb. 7, 1996, available at LEXIS, News Library, Bloomberg File (quoting one compensation executive that guaranteed bonuses, perks, and even base salaries “are out of vogue” and that “incentives and stock options are in”); Matt Richtel, *Need for Computer Experts Is Making Recruiters Frantic*, N.Y. TIMES, Nov. 18, 1999, at A1 (noting that recruiters entice computer technicians and engineers with generous perquisites, including stock options).

⁴ See Michael S. Malone, *Nerds' Revenge: A How-To Manual*, N.Y. TIMES, Feb. 18, 1996, § 3, at 1 (noting that after initial public offering, Netscape employees had instant personal fortunes); Eryn Brown, *Fortune's 40 Under 40: Valley of the Dollars; The Young, Wealthy Netheads of San Francisco and Silicon Valley Protest That It's Not About the Money. Give Us A Break*, FORTUNE, Sept. 27, 1999, at 100 (stating that “[m]ost people who have a few million dollars have been compensated in options from one of the big superstar companies”); Judith H. Dobrzynski, *Chief Executive Puts Stock-Only Pay to Ultimate Test*, N.Y. TIMES, Oct. 4, 1996, at D1 (describing chief executive of Ingram Micro, Inc.'s stock option-only compensation package).

⁵ See Michael McDonald, *California 'Model' Had Law Firms in New York Chasing Fool's Gold; Equity Stakes, Expensive Staffs Don't Pan Out*, CRAIN'S N.Y. BUS., Mar. 26, 2001, at 13 (noting that “Brobeck's decision to take equity stakes as part of its fee seemed like genius” and that Shearman & Sterling and Wilson Sonsini also took fees in clients' stock in lieu of cash).

⁶ For example,

Research by Joseph Blasi at Rutgers University found that 97 of the top 100 e-commerce companies offer options to most or all employees. A 1997 survey of 1,100 public companies conducted by ShareData, Inc., and the American Electronics Association found that 53% of respondents provide options to all employees. A 1999 William Mercer study showed that options are popular in all kinds of public companies, with 17% of large public companies offering options to most or all employees.

Employee Stock Options Fact Sheet, 2002, at <http://www.nceo.org/library/optionfact.html> (last visited Mar. 20, 2002).

⁷ See DENNIS R. LASSILA & BOB G. KILPATRICK, U.S. MASTER COMPENSATION TAX GUIDE ¶ 1502.02 (2d ed. 1999). ISOs provide favorable tax treatment compared to other forms of compensation. See Thomas Z. Reicher et al., *Statutory Stock Options*, 381 Tax Mgmt. (BNA), at A18 – A19 (2001); see also *infra* Part II.B.3.

⁸ See *New Data Show Venture-Backed Companies Still Issue Options Broadly*, 2002, at http://www.nceo.org/library/option_venturebacked.html (last visited Mar. 20, 2002) (not-

B. "The Worst of Times"

Then the stock market bubble burst, and the unbridled exuberance transformed itself into rising unemployment, dramatic capital losses for investors, vacancies for property owners, and recession.⁹ For many employees, lay-offs and retirement-plan losses were only the beginning of the worst of times. Just when they thought things could not get any worse, the tax man poured salt into their wounds.

Employees who enthusiastically exercised ISOs during the 2000 tax year, believing that their "phantom gains" were tax free, soon discovered that they owed massive amounts of Alternative Minimum Tax ("AMT").¹⁰ The employees incurred AMT on their economic income from the exercised options, measured as of the date of exercise, even though much of this paper income had disappeared long before the end of the 2000 tax year.¹¹ In many cases, the AMT consequences of ISO exercises took unsuspecting employees by surprise and caught them without sufficient cash to pay their AMT on April 15, 2001.¹²

As these unsuspecting employees work through their financial and emotional challenges, many have joined together in a grassroots effort to change the tax law.¹³ This effort is exemplified by ReformAMT, a grassroots tax reform informational and advocacy group.¹⁴ The movement to

ing that 82% of 275 high-tech companies recently surveyed provide ISOs rather than non-qualified stock options and that 62% provide only ISOs).

⁹ See Richard W. Stevenson, *Economists Make It Official: U.S. Is in Recession*, N.Y. TIMES, Nov. 27, 2001, at C1 (stating that the National Bureau of Economic Research has concluded that the U.S. economy entered a recession in March of 2001); Leslie Eaton and Jayson Blair, *Silicon Alley's Dimming Lights*, N.Y. TIMES, Oct. 27, 2000, at B1; see also *The Tech Economy: Silicon Valley Party Literally Over; Once-Vibrant Dot-Com Bash Scene Among Casualties of Area's Burst Bubble*, INVESTOR'S BUS. DAILY, May 18, 2001, at A4 (estimating that 327 internet companies folded between January 2000 and February 2001 and 8,000 high-tech workers in Silicon Valley lost their jobs from October to May 2001).

¹⁰ See Ryan J. Donmoyer, *Riches to Rags: Workers Ambushed by Tax on Options*, BLOOMBERG NEWS, Aug. 8, 2001, available at LEXIS, News Library, Bloomberg File (stating that internet and technology workers who received and lost millions of dollars of stock value from year 2000 option exercises want Congress to relieve them from more than \$1 billion of AMT). Congress enacted the AMT in 1969 in response to concern that certain high-income individuals were using deductions and exclusions available in the regular income tax system to avoid paying any tax. H.R. REP. NO. 91-413, at 9-10 (1969). The AMT system operates in addition and parallel to the regular income tax system to ensure that these taxpayers pay a minimum amount of tax. See I.R.C. § 55 (All I.R.C. references in this Essay are to the 2001 version).

¹¹ See Matt Richtel, *Stock Option Blues: Slide Leaves Little but a Big Tax Bill*, N.Y. TIMES, Feb. 18, 2001, § 1, at 1.

¹² See *id.*; see also Donmoyer, *supra* note 10 (describing one taxpayer's \$1.9 million AMT debt and financial ruin).

¹³ See Liz Pulliam Weston et al., *Tech Workers' Stock Options Turn into Tax Nightmares*, L.A. TIMES, Apr. 13, 2001, at A1.

¹⁴ For information about the organization's mission, see the ReformAMT Web site, at <http://www.reformamt.org> (last visited Mar. 20, 2002). In March 2002, ReformAMT had about 1590 members. See ReformAMT Geographic Membership, at <http://www.kls2.com/>

reform the AMT has attracted support from many members of Congress.¹⁵ Senator Joseph I. Lieberman (D-Conn.) and House Ways and Means Committee member Richard E. Neal (D-Mass.) have introduced legislation to provide tax relief for individuals who exercised ISOs during calendar year 2000.¹⁶ These bills have bipartisan support and an estimated cost of \$1.3 billion over ten years.¹⁷ ReformAMT acknowledges that its cause may not garner sympathy from those who believe that its members are just “dot.com millionaires who do not want to pay their taxes.”¹⁸ However, ReformAMT has made admirable strides in focusing attention on the AMT system. This attention is critical and timely. Recent estimates indicate that the AMT will generate more than \$600 billion of tax revenue through 2011 and, more significantly, by 2010 will impact approximately thirty-three percent of all taxpayers, most of whom are not dot.com millionaires.¹⁹

C. *The AMT and the Exercise of ISOs*

This Essay argues that, while extensive reform of the AMT is necessary, the exercise of ISOs should continue to result in a positive AMT adjustment to regular taxable income, and thus remain subject to AMT taxation. Congress enacted the AMT to ensure that high-economic income individuals who reduce their regular tax liability through income exclusions or deductions pay some amount of tax. The positive AMT adjustment for ISO exercises ensures that employees who realize a significant amount of otherwise excluded bargain purchase income pay some tax. Elimination of this adjustment would be inconsistent with congressional intent to limit ISO benefits and to tax individuals with high economic income.

The exercise of an ISO results in an employee’s realization of economic income equal to the positive difference between the fair market

reformamt/geomembers.html (last visited Mar. 20, 2002).

¹⁵ For a list of AMT-related legislation, see Active Legislation, at <http://www.reformamt.org/legislation.php> (last visited Mar. 20, 2002).

¹⁶ See *Lieberman Bill Would Provide AMT Relief for Incentive Stock Options*, 92 TAX NOTES 1196 (2001); *Neal Bill Would Provide AMT Relief for Incentive Stock Options*, 92 TAX NOTES 1194 (2001); see also Active Legislation, at <http://www.reformamt.org/legislation.php> (last visited Mar. 26, 2002). On April 4, 2001, Representative Zoe Lofgren (D-Cal.) sponsored a bill in the House of Representatives, H.R. 1487, which would repeal the AMT adjustment for ISO exercises in 2000 and thereafter. See 147 CONG. REC. H1487 (daily ed. Apr. 4, 2001).

¹⁷ See *Lieberman Bill Would Provide AMT Relief for Incentive Stock Options*, 92 TAX NOTES 1196 (2001); Sponsorship of H.R. 2794 (noting that twenty-four Republicans and twenty-four Democrats are sponsors), at <http://www.kls2.com/cgi-bin/hrspon?bill=hr2794> (last visited Mar. 21, 2002).

¹⁸ See About ReformAMT, at <http://www.reformamt.org/about.php> (last visited Mar. 20, 2002).

¹⁹ See Heather Bennett, *EGTRRA Will Subject ‘Startling’ Number of Taxpayers to AMT By 2010*, 93 TAX NOTES 1150, 1150–51 (2001).

value of the stock at the date of exercise and the exercise price paid ("bargain purchase income"). In the case of the exercise of a non-qualified stock option ("NQSO"),²⁰ or of most other employee purchases of assets for less than market value ("bargain purchase"), this bargain purchase income must be included in an employee's gross income and is subject to income and payroll taxes as compensation.²¹

Qualifying exercises of an ISO receive favorable tax treatment.²² The bargain purchase income realized through the exercise of an ISO is specifically excluded from gross income.²³ However, Congress has limited this favorable treatment by including ISO bargain purchase income as a positive AMT adjustment to regular taxable income to determine whether a taxpayer owes AMT.²⁴ The AMT was enacted to impose tax liability on high-income individuals who otherwise could avoid paying taxes through artful manipulations of deductions and exclusions.²⁵ Given this congressional intent, it is appropriate to include otherwise excludable economic income such as ISO bargain purchase income as a positive AMT adjustment and subject it to AMT to limit the extent to which individuals can escape tax liability.

²⁰ Options that do not qualify for tax-favored treatment under I.R.C. § 421 are NQSOs. Any income an employee realizes from the exercise of NQSOs is subject to ordinary income and payroll taxes under the general rules for transfers of property for services. *See* I.R.C. § 83.

²¹ Any benefit an employee receives from her employer must be included in gross income as compensation subject to ordinary income and payroll taxes, unless Congress has specifically excluded it. *See* I.R.C. §§ 61(a), 83 (defining gross income for ordinary income tax); *id.* § 3121(a) (defining wages for payroll tax). Thus when an employee realizes bargain purchase income from her exercise of an NQSO or other bargain purchase, the income is usually subject to taxation. In such purchases, the employee receives a benefit from her employer, in that she can purchase stock or some other asset at a price below its fair market value. This is analogous to a cash bonus to buy the asset. Like any cash payment, bonus, fringe benefit, or other accession to wealth, this benefit must be included in gross income unless Congress specifically has excluded it. *See id.* §§ 61(a), 83.

²² Congress instituted tax-favored employee stock options, that is, ISOs, in 1981 under the Economic Recovery Tax Act of 1981, Pub. L. No. 97-34, § 251, 95 Stat. 172, 256-59 (amending I.R.C. §§ 421-25). An employee who receives ISOs from her employer does not have to recognize any compensation on the grant or exercise of the ISOs. *See* I.R.C. § 421(a)(1). Moreover, when the employee sells her ISO stock, any appreciation is subject to tax at favorable long-term capital gains tax rates. *See id.* § 1(h) (setting a maximum long-term capital gains tax rate of 20%). Thus, tax-favorable treatment for ISOs effectively converts compensation (currently subject to ordinary income tax rates of up to 38.6%) into long-term capital gains (subject to tax rates up to 20%) and defers recognition of any capital gain until the employee decides to sell the stock. *See id.* §§ 1(h)-(i), 1001, 1222; Rev. Proc. 2001-59, 2001-52 I.R.B. 623, § 3.01.

²³ *See* I.R.C. §§ 421(a)(1), 422(a).

²⁴ *See id.* § 56(b)(3). As a result, if an employee's alternative minimum taxable income—including bargain purchase income—is large enough, she may have to pay AMT on the bargain purchase income in the year of exercise. *See id.* § 55(b).

²⁵ *See* H.R. REP. NO. 91-413, at 9-10 (1969). A study of 1966 high-income tax returns found 154 taxpayers with adjusted gross incomes greater than \$200,000 who nonetheless had no income tax liability. Twenty-one of the taxpayers in the study had incomes of over \$1 million. DANIEL J. LATHROPE, *THE ALTERNATIVE MINIMUM TAX: COMPLIANCE AND PLANNING WITH ANALYSIS* ¶ 1.01 (1994).

While many ISO exercisers experienced significant adverse AMT consequences in 2000, the problem is not that they are unique in having to pay tax on assets that have declined significantly in value. The same tax consequences result whenever any taxpayer acquires an asset with after-tax dollars and the asset subsequently declines in value. The taxpayer has realized and recognized income and must pay any applicable taxes. If the taxpayer uses her after-tax dollars to make an equity investment that subsequently declines, she cannot then adjust the original amount of income recognized to reflect the asset's later value. The taxpayer will only recognize a tax loss and reduce her tax liability if she sells her equity holding at a loss, and this tax loss would be significantly limited under the current capital loss limitation rules.²⁶

In fact, taxpayers exercising ISOs benefit from an exceptional exclusion from regular income tax on their realized economic income.²⁷ If this realized economic income is significant, then the taxpayer might be subject to the AMT. However, the maximum marginal AMT rate is only 28%, versus the current highest marginal ordinary income tax rate of 38.6%.²⁸ Therefore, even if ISO bargain purchase income is subject to AMT, it is subject to taxation at a lower rate than the applicable tax rate for ordinary income not excluded under the regular income tax system.

The real problem is the extreme complexity and lack of transparency in the federal income tax system. Taxpayers who exercise ISOs often do not understand that there are any income tax consequences, so they do not act in an informed manner to plan the exercises optimally.²⁹

Part II of this Essay begins with a brief explanation of the AMT followed by a presentation of the current state of the tax consequences of transactions involving ISOs and NQSOs. Understanding these consequences is challenging because of the extreme complexity of the relevant

²⁶ See I.R.C. § 1211(b) (limiting tax losses from the sale or exchange of a capital asset to the amount of capital gains plus up to \$3,000 (\$1,500 for married taxpayers filing separately)).

²⁷ Exclusion from gross income is the exception to the general rule of inclusion. See *id.* § 61. Unless specifically excluded, benefits received by employees from their employers are included in gross income as compensation. See *id.* Employee benefits such as certain life insurance benefits, cash bonuses, certain meal and moving allowances, and bargain purchases, including the exercise of an NQSO, must be included in gross income as compensation. See *id.* §§ 61, 79, 82, 83, 132. However, the bargain purchase income an employee realizes from the exercise of an ISO is excluded specifically from gross income. See *id.* § 421.

²⁸ See *id.* § 55(b)(1)(A)(i) (AMT rates); Rev. Proc. 2001-59, 2001-52 I.R.B. 623, § 3.01 (setting forth 2002 individual regular income tax rates ranging from 10 to 38.6%).

²⁹ See Weston, *supra* note 1, at C1 (describing widespread misunderstanding regarding tax consequences of ISOs and communication of misinformation by companies to their own employees); see also Amy Hamilton, *Advocate Sends Simplification Proposals to Congress*, 94 TAX NOTES 7, 8 (2002) (National Taxpayer Advocate Olson comments that, due to the AMT's complexity, a large number of taxpayers do not know that they have AMT liabilities.).

tax law.³⁰ After working through the intricacies of the general tax consequences presented in Part II, the reader should appreciate the complexity of congressional efforts and the confusion of affected taxpayers.

Part III explains the ever-growing problems in the AMT system. This explanation includes an overview of ReformAMT, its members, and its grassroots efforts to educate the public and Congress about the impact of the AMT on ISO exercisers. It also describes legislative responses to ReformAMT's concerns and lobbying efforts. Part III then details the most commonly proposed modifications to the AMT, which do not include elimination of the positive AMT adjustment for the bargain purchase income realized from an ISO exercise. They do include indexing the AMT system for inflation and allowance of state and local tax and personal and dependency exemptions as deductible items under the AMT.³¹ These model reforms should decrease significantly the number of taxpayers subject to the AMT, including some ISO exercisers. By simplifying the AMT, taxpayers, including ISO exercisers, should be able to understand better the application of and calculations for the AMT. Taxpayers who understand how the simplified AMT operates should be able to manage the exercise of their ISOs more efficiently to minimize their overall tax costs, including any AMT.

Part IV describes why the elimination of the positive AMT adjustment for the bargain purchase income resulting from an ISO exercise is not a desirable AMT reform. While Congress provided tax-favored treatment for ISOs,³² it also imposed certain limitations on these tax benefits.³³ Along with qualifications on the favored treatment of stock options under the regular income tax,³⁴ if ISO benefits and other income received exceed certain thresholds, then the ISO bargain purchase income is subject to AMT.³⁵ Congress enacted the AMT to ensure that taxpayers with significant economic income pay some tax.³⁶ This Essay argues that the positive AMT adjustment for the economic income realized by an

³⁰ Daniel Shaviro, *Tax Simplification and the Alternative Minimum Tax*, 91 TAX NOTES 1455, 1457-58 (2001) (noting that taxpayers annually spend over 29 million hours completing and filing the AMT tax form and that more than ten percent of tax returns with AMT—most of which were completed by paid preparers—had errors in the AMT calculation); Hamilton, *supra* note 29, at 8 (National Taxpayer Advocate states that the fifty-four-line AMT form, with ten pages of instructions and a thirteen-line worksheet, is too complicated for taxpayers to use without professional help).

³¹ Currently, taxpayers must add back deductions for state and local taxes and personal and dependency exemptions to compute alternative minimum taxable income. See I.R.C. § 56(b)(1)(A)(ii), (b)(1)(E). Under the proposed AMT reforms, they would not have to add back such deductions and exemptions. The reforms would also increase exemption amounts and index tax rates and exemptions for inflation. This would reduce potential AMT liability and thus decrease the number of taxpayers paying AMT. See *infra* Part III.C.

³² See I.R.C. §§ 421(a), 422(a).

³³ See *id.* § 422(b)(1)-(6), (d).

³⁴ See *id.*

³⁵ See *id.* §§ 56(b)(3), 55(b).

³⁶ See H.R. REP. NO. 91-413, at 9-10 (1969).

ISO exerciser is consistent with congressional intent to limit ISO benefits and to ensure that high economic income individuals have tax liability.

Part V demonstrates that the AMT treatment of ISOs merely puts them on par with other employee benefits, including NQSOs and other employee bargain purchases.³⁷

II. THE AMT AND EMPLOYEE STOCK OPTIONS

A. *What Is the AMT?*

Congress instituted the AMT as a separate tax system that would parallel the regular income tax system by creating tax liability for certain individuals who otherwise would have none. The Code imposes the AMT on every taxpayer subject to the regular tax.³⁸ The AMT system is basically a flat tax that applies the same tax rate to all classes of taxpayers, whether married, single, or head of household.³⁹ The manner in which income is computed for AMT purposes often translates into a higher tax liability.

Taxpayers compute their AMT using an expanded tax base called alternative minimum taxable income ("AMTI"),⁴⁰ which is determined by adding or subtracting certain listed adjustments and preferences to regular taxable income.⁴¹ These adjustments and preferences include, inter alia, all state and local taxes, deductible miscellaneous itemized deductions, certain interest on home equity loans, the standard deduction, all personal and dependency exemptions, the bargain purchase income realized in an ISO exercise, the exclusion for capital gains on the sale of qualified small business stock, and certain accelerated depreciation deductions.⁴² Taxpayers then subtract an exemption amount to determine the "taxable excess."⁴³ The exemption amount is phased out completely when AMTI exceeds a certain threshold dollar amount.⁴⁴ After determining "taxable excess," the taxpayer calculates "tentative minimum tax" by applying a tax rate of 26% on the first \$175,000 of taxable excess, and a 28% tax rate on the balance.⁴⁵ If a taxpayer's tentative minimum tax is

³⁷ See J. COMM. ON TAXATION, 106TH CONG., OVERVIEW OF FEDERAL INCOME TAX PROVISIONS RELATING TO EMPLOYEE STOCK OPTIONS, JCX-107-00, at 2 (2000) (stating that ISO transactions under the AMT are treated the same as NQSO transactions).

³⁸ I.R.C. § 55(a).

³⁹ Michael J. Graetz, *The 1982 Minimum Tax Amendments as a First Step in the Transition to a 'Flat-Rate' Tax*, 56 S. CAL. L. REV. 527, 550-554 (1983).

⁴⁰ I.R.C. § 55(b)(2).

⁴¹ *Id.*

⁴² *Id.* §§ 56-57.

⁴³ *Id.* § 55(d).

⁴⁴ *Id.*

⁴⁵ *Id.* § 55(b)(1).

higher than the taxpayer's regular income tax, the taxpayer must pay the higher amount.⁴⁶

B. ISOs

1. ISOs Explained

Congress has provided special tax-favored rules for ISOs.⁴⁷ The Code's ISO provisions allow an employee to convert ordinary income realized from the performance of services, which currently is subject to a maximum federal marginal income tax rate of 38.6%,⁴⁸ into long-term capital gain, which currently is subject to a maximum federal capital gain tax rate of 20%.⁴⁹ Moreover, the employee recognizes capital gain at the time that she sells her shares, not when she receives them through her bargain purchase. Other transfers of property for the performance of services are subject to tax at ordinary income tax rates at the time of the transfer of property.⁵⁰ Accordingly, ISOs provide employees with two significant tax-favored treatments: (1) the bargain purchase income of the ISO is subject to tax at preferential long-term capital gain tax rates; and (2) recognition of income is deferred until the shareholder engages in a sale or exchange of the ISO stock.

The Senate Finance Committee enacted the ISO provisions in 1981 with the intention of "provid[ing] an important incentive device for corporations to attract new management and retain the service of executives, who might otherwise leave, by providing an opportunity to acquire an interest in the business."⁵¹ Congress believed that encouraging "management of a business to have a proprietary interest in its successful operation [would] provide an important incentive to expand and improve the profit position of the companies involved."⁵²

Many academics and business executives question whether stock options accomplish this objective.⁵³ Economic studies regarding the ef-

⁴⁶ *Id.* § 55(a).

⁴⁷ *Id.* § 421.

⁴⁸ *Id.* § 1(a)-(d); Rev. Proc. 2001-59, § 3, 2001-52 I.R.B. 623 (setting forth 2002 tax rate tables for individual taxpayers under I.R.C. § 1(a)-(d), with ordinary income tax rates ranging from 10% to 38.6%).

⁴⁹ I.R.C. § 1(h).

⁵⁰ *Id.* § 83 (gross income includes the transfer of property for services to the extent of the excess of the fair market value of the unrestricted property over the amount, if any, paid for such property).

⁵¹ S. REP. NO. 97-144, at 98 (1981).

⁵² *Id.*

⁵³ See James R. Repetti, *Accounting and Taxation: The Misuse of Tax Incentives to Align Management-Shareholder Interests*, 19 CARDOZO L. REV. 697, 701 (1997) (quoting Warren Buffett's observation in 1985 that "[o]nce granted the option is blind to individual performance. Because it is irrevocable and unconditional (so long as a manager stays in the company), the sluggard receives rewards from his options precisely as does the star.").

fectiveness of stock options in enhancing business profits are inconclusive: "Although some studies conclude that the stock market reacts positively to the initial adoption of stock option plans, most studies are uncertain about whether stock options or increased executive stock ownership actually contribute to corporate profitability."⁵⁴

At least one commentator suggests that congressional skepticism about ISOs' motivational effectiveness led Congress to enact the AMT in order to limit the tax-favored treatment of ISOs.⁵⁵ That same commentator, however, criticizes this approach to tax policy and suggests that "[r]ather than express ambivalence in the Code, Congress should eliminate either the favorable regular income tax treatment of incentive stock option provisions or the unfavorable alternative minimum tax treatment."⁵⁶ He concludes that Congress should eliminate the favored regular tax treatment, which effectively would obviate the need for any AMT consequences.⁵⁷

2. *Qualification for ISO Treatment Under the Code*

To qualify for favorable tax treatment, the ISO and its holder must satisfy several statutory requirements.⁵⁸ The ISO must have been granted to an employee, pursuant to a plan adopted by stockholders, within ten years from the date the plan is either adopted or approved by shareholders, whichever is earlier; the option must not be exercisable after the expiration of ten years from the date of grant; the option cannot be transferable except by will "or by the laws of descent or distribution" and must be exercisable only by the grantee during his lifetime; and it must have an exercise price equal to or greater than the stock's fair market value at the time of grant.⁵⁹ The option holder must "not own stock possessing more than 10% of the total combined voting power of all classes of stock of the employer corporation or of its parent or subsidiary corporation."⁶⁰ The holder of the ISO must hold the stock purchased under the option for a minimum of two years from the receipt of the option and one year from the exercise of the option.⁶¹ Moreover, the holder must be an employee of

⁵⁴ *Id.* (citing, among others, James A. Brickley et al., *The Impact of Long-Range Managerial Compensation Plans on Shareholder Wealth*, 7 J. ACCT. & ECON. 115 (1985) and Kevin J. Murphy, *Corporate Performance and Managerial Remuneration: An Empirical Analysis*, 7 J. ACCT. & ECON. 11, 19, 29, 32 (1985) (finding no statistical relationship between current year's stock option awards and performance)).

⁵⁵ *Id.* at 702.

⁵⁶ *Id.* at 703.

⁵⁷ *Id.* (suggesting an elimination of the favorable regular income tax treatment and revision of provisions in the Code "that contribute to management's tendency to behave inefficiently:").

⁵⁸ I.R.C. § 422.

⁵⁹ *Id.* § 422(b)(1)–(5).

⁶⁰ *Id.* § 422(b)(6).

⁶¹ *Id.* § 422(a)(1).

the issuer, or its parent or subsidiary corporation, at all times from the grant of the ISO until three months before its exercise.⁶²

In addition to these conditions, Congress also has limited the tax-favored benefits of ISOs through a \$100,000 per year limit. The aggregate fair market value of stock with respect to which ISOs are first exercisable during a calendar year is limited to \$100,000 per year, measured at the time of the grant.⁶³

3. *Tax Treatment of ISOs*

a. *Grant of an ISO*

A transfer of property in connection with the performance of services is an income recognition event for the recipient of the property.⁶⁴ The amount of recognizable income is equal to the fair market value of the property less the amount, if any, paid by the recipient for such property (any bargain purchase income).⁶⁵ For instance, if an employer gives its employee a new car, the fair market value of the car less the amount, if any, paid by the employee for the car is included in the employee's gross income and is subject to income and payroll taxes.

Under this tax provision, an employer's grant of an ISO to its employee is a transfer in connection with the performance of services that normally would cause an income recognition event for the employee. One of the tax benefits of ISOs, however, is that an employee does not have to recognize any taxable income upon the grant, because the Code and the related Treasury Regulations exclude an ISO grant from classification as a "transfer of property."⁶⁶ The Treasury Regulations specifically state that an ISO grant is not a transfer of the underlying property.⁶⁷ An employee must recognize income only if an employer transfers property in connection with the provision of services. Because an ISO grant is not a transfer of property, employees do not recognize any income upon the grant of an ISO.

b. *Exercise of an ISO: Regular Tax Consequences and AMT Tax Consequences Compared*

The primary tax benefit of an ISO is that an employee does not recognize income—either as ordinary income or capital gain—upon the ex-

⁶² *Id.* § 422(a)(2).

⁶³ *Id.* § 422(d).

⁶⁴ *Id.* § 83(a)(1).

⁶⁵ *Id.* § 83(a)(1)–(2).

⁶⁶ Treas. Reg. § 1.83-3(a)(2) (as amended in 1985).

⁶⁷ *Id.*

ercise of the ISO.⁶⁸ However, when calculating taxable income for AMT purposes, the bargain purchase income of the ISO must be included in AMTI for the year in which the option is exercised.⁶⁹ AMT paid as a consequence of an ISO exercise will result in an AMT credit for use in future tax years.⁷⁰ The AMT credit is allowed as an offset against a taxpayer's regular tax liability to the extent of the excess of the regular tax liability over tentative minimum tax.⁷¹ Furthermore, this AMT credit can be carried forward indefinitely.⁷²

The tax treatment of the disposition of ISO stock also depends upon whether the stock is disposed of within the statutorily required holding period. The statutory ISO holding period begins on the date the employee exercises her ISOs and ends on the date that is the later of: (1) two years from the date of the ISO grant; or (2) one year from the date on which the ISO stock was transferred to the employee upon ISO exercise.⁷³

A qualifying disposition results if the employee disposes of the stock after the end of the statutory period. An employee disposing of ISO stock after the end of the statutory holding period will recognize a long-term capital gain equal to the positive difference between the sale proceeds and the employee's basis in the stock.⁷⁴ For regular income tax purposes, an employee's basis in her ISO stock is the exercise price; that is, the dollar amount paid by the employee for the shares of stock.⁷⁵ For AMT purposes, an employee's basis in her ISO stock is larger because it includes not just the amount paid by the employee for the shares, but also the bargain purchase income included in the shareholder's AMT in-

⁶⁸ I.R.C. §§ 421(a)(1), 422(a).

⁶⁹ *Id.* § 56(b)(3). The "bargain purchase element" or the excess of the fair market value of the ISO stock at exercise over the exercise price is treated as an "item of adjustment" for AMT purposes. Originally, the "bargain purchase element" was a tax preference item. However, the Technical and Miscellaneous Revenue Act of 1988 ("TAMRA") reclassified the item as an item of adjustment, effective with respect to options exercised after 1987. Technical and Miscellaneous Revenue Act of 1988, Pub. L. No. 100-647, § 1007(b)(14)(A), 102 Stat. 3342, 3430. The AMT provisions, I.R.C. § 56(b)(3), provide that the nonrecognition provisions found in I.R.C. § 421 do not apply to the exercise of an ISO for AMT purposes. Therefore, the I.R.C. § 83(e)(1) exclusion from the application of I.R.C. § 83 does not apply. Accordingly, the bargain element is included in AMT income when the holder exercises her ISOs. If the shares received from her exercise are subject to a substantial risk of forfeiture as defined in I.R.C. § 83 and the related Treasury Regulations, the date for the calculation of the preference adjustment and for inclusion of the adjustment in the calculation of AMTI is the date the restrictions lapse. The taxpayer may file an I.R.C. § 83(b) election within thirty days following the exercise of the ISO and, thereby, elect to include the bargain element in income as of the date of exercise, and not when the substantial risk of forfeiture lapses, if at all.

⁷⁰ I.R.C. § 53.

⁷¹ *Id.*

⁷² *Id.*

⁷³ *Id.* § 422(a)(1).

⁷⁴ *Id.* § 1001. If the employee's basis in her ISO shares is greater than the sale proceeds, she will realize and recognize a capital loss subject to any capital loss limitations. *Id.* § 1211(b).

⁷⁵ *Id.* §§ 1011, 1012.

come.⁷⁶ The bargain purchase income consists of the positive difference between: (1) the ISO exercise price; and (2) the fair market value of the ISO stock at the time of option exercise.⁷⁷

If an employee disposes of ISO stock before the statutory holding period expires, the disposition is considered a “disqualifying disposition,” which is treated differently under the regular income tax system and the AMT system if the ISO exercise and the disqualifying disposition occur in different tax years.⁷⁸

To understand treatment under the regular income tax system, first consider what happens when the stock price increases after the date of exercise. In the case of a disqualifying disposition, the employee generally must recognize the bargain purchase income, measured as of the date of exercise, as ordinary income,⁷⁹ and any stock appreciation occurring after the date of exercise is characterized as capital gain.⁸⁰ The capital gain will be long-term or short-term, depending upon whether or not the employee held her shares for more than one year after the ISO exercise.⁸¹

The results change when the stock price decreases after the date of exercise. When the price received by an employee who sells her stock in a disqualifying disposition is less than the fair market value of the stock on the exercise date, the amount of ordinary income she recognizes is the excess, if any, of the amount realized on the sale over her tax basis in her ISO stock.⁸² Any recognized loss is fully deductible against the bargain purchase income realized on the date of exercise.⁸³ Therefore, the amount

⁷⁶ *Id.* § 56(b)(3). An employee’s gain on the sale of her ISO stock will be a smaller amount for AMT purposes, because the employee has already recognized as income the bargain element in the exercise of the ISOs.

⁷⁷ Under the AMT, I.R.C. § 421 does not apply; therefore, the bargain purchase income resulting from the ISO exercise must be included in AMTI. *Id.* §§ 56(b)(3), 83.

⁷⁸ See *supra* note 73 and accompanying text.

⁷⁹ Prop. Treas. Reg. § 1.422A-1(b)(1), 49 Fed. Reg. 4507 (Feb. 7, 1984). Because the option has failed to qualify as an ISO, the Code provides that the exercise of the option is treated as any other transfer of property for services. I.R.C. § 83. Accordingly, the employee must include in gross income the excess of the fair market value of the shares of stock (as of the date of exercise) over the amount paid for the stock, if any, in the taxable year in which the disqualifying disposition occurred. *Id.* §§ 83, 421(b); see also Reicher et al., *supra* note 7, at A9.

⁸⁰ I.R.C. § 1001(c).

⁸¹ *Id.* §§ 1222–1223. For example, on December 28, 1998, Company grants Employee 100 ISOs to purchase shares of Company stock at \$15 per share, the fair market value of the stock on the date of grant. On April 15, 2000, Employee exercises all 100 ISOs, when the stock price has increased to \$20 per share. On December 31, 2000, Employee sells the shares of stock for \$26 per share. The sale of the stock was a disqualifying disposition (that is, the employee did not hold the ISO shares for at least one year from the date of exercise). *Id.* § 421(a)(1). Employee must recognize \$500 of bargain purchase income as ordinary income in 2000 (\$20 fair market value on date of exercise less \$15 amount paid = \$5 x 100 shares). *Id.* §§ 83, 421(b). Additionally, Employee must recognize a \$600 short-term capital gain in 2000 (\$26 sales proceeds less \$20 basis in shares sold within one year = \$6 x 100). *Id.* § 1001, 1222; see Reicher et al., *supra* note 7, at A9.

⁸² I.R.C. § 422(c)(2).

⁸³ *Id.* §§ 56(b)(3), 422(c)(2). For example, using the same facts as set forth in *supra*

of the bargain purchase income recognized is limited to any gain realized on the sale.⁸⁴ However, if the loss is not otherwise recognized under the Code, then the entire amount of the bargain purchase income as of the date of the exercise must be included in gross income.⁸⁵ The amount of bargain purchase income recognized is added to the employee's basis in her stock.⁸⁶ Thus, the stock sale will result in a capital loss, which will be disallowed under the applicable nonrecognition provision.⁸⁷ Accordingly, the employee must recognize all of her bargain purchase income measured as of the date of exercise as ordinary income and the subsequent decrease in stock value is characterized as a capital loss. However, the capital loss cannot offset any amount of recognized income, because the Code has otherwise disallowed it (e.g., capital losses resulting from a "wash sale" are disallowed).⁸⁸

The AMT treatment will differ depending on whether or not the disqualifying disposition occurs in the same year as the options are exercised. When a shareholder sells her shares in a disqualifying disposition, her income for regular tax purposes and AMT purposes is the same so long as the sale occurs in the same tax year that she exercised her ISOs.⁸⁹ As noted above, under the regular tax system the shareholder has to recognize the bargain purchase income as ordinary income.⁹⁰ If the shares are sold for an amount less than the fair market value of the shares on the date of exercise, however, then the amount of ordinary income recognized is limited to any gain realized.⁹¹ Because the regular tax system and the AMT system afford the same treatment, the shareholder will not have

note 81, assume that Employee sells the shares for \$18 (an amount less than the \$20 value of the shares on the date of exercise). Employee only recognizes \$300 of bargain purchase income as ordinary income in 2000 (\$18 sale price less amount paid \$15 = \$3 x 100 shares). See Reicher et al., *supra* note 7, at A10. However, if the loss is not otherwise recognizable (e.g., due to a "wash sale" under I.R.C. § 1091 or related party sale under I.R.C. § 267), then the realized loss cannot be offset against the bargain purchase income. I.R.C. § 422 (c)(2); see also Reicher et al., *supra* note 7, at A10–A11; *infra* note 98 and accompanying text (discussing hypothetical application of the "wash sale" rules to Jeffrey Chou). In such case, Employee would have to recognize the bargain purchase income of \$500 as of the date of exercise (\$20 fair market value at date of exercise less \$15 amount paid = \$5 x 100 shares). Employee would increase her tax basis in the shares sold by the recognized bargain purchase income. I.R.C. § 1012. Thus, the employee also would realize a capital loss of \$200 in 2000 (\$18 sales price less \$20 tax basis = \$2 x 100 shares), which the taxpayer could not recognize under the wash sale rules. *Id.* § 1091(a). These tax consequences are the same for any transfer of property for services, *id.* § 83, where the property is later sold at a loss in a transaction in which the taxpayer cannot recognize the loss. See, e.g., *id.* §§ 1091, 267, 165(c).

⁸⁴ I.R.C. § 422(c)(2).

⁸⁵ *Id.*

⁸⁶ *Id.* § 1012.

⁸⁷ See, e.g., *id.* §§ 1091, 267.

⁸⁸ *Id.* § 1091.

⁸⁹ *Id.* §§ 56(b)(3), 422(c)(2); HR REP. NO. 100-795, at 90 (1988); S. REP. NO. 100-445, at 96 (1988).

⁹⁰ See *supra* note 79 and accompanying text.

⁹¹ I.R.C. § 422(c)(2).

any AMT adjustment for her exercise if both the exercise and the disqualifying disposition take place in the same tax year.⁹²

As a result, an employee may eliminate her AMT adjustment by selling her shares before the end of the tax year when their fair market value drops below what it was on the exercise date. However, if she repurchased the same company stock within thirty days before or after the sale date, a “wash sale,”⁹³ then the employee will have to recognize the bargain purchase income as of the date of exercise as ordinary income subject to less favorable ordinary income tax rates, and the loss realized on the sale of stock will be disallowed.⁹⁴

c. Real Life Experiences with AMT

To illustrate the complexity of the system, consider the following real life scenario involving taxpayer Jeffrey Chou, leader of the grassroots organization ReformAMT, and his wife Cindy.⁹⁵ In 2000, the Chous exercised ISOs to buy approximately 100,000 shares of stock in Cisco Systems, Inc. (“Cisco”) at five to ten cents per share. At the time of the exercise, Cisco was trading between sixty dollars and seventy dollars per share. As a result of the ISO exercise, Jeffrey and Cindy Chou did not have any recognition of regular taxable income, but they had a positive AMT adjustment equal to the bargain purchase income from their exercise. Because of the enormous discrepancy between the ISO exercise price and the fair market value, the AMT adjustment totaled almost \$7 million. This significant positive AMT adjustment and the Chous’ other AMT adjustments translated into over \$2.5 million of AMT and state income tax. By the end of 2000, Cisco had dropped to thirty-seven dollars per share, significantly reducing the value of the Chous’ assets and making it difficult for them to pay the AMT owed.

The Chous would not have found themselves in such a difficult situation if they had understood the relevant tax provisions. If the Chous

⁹² See Weston et al., *supra* note 13 (suggesting that federal tax law offers an out for those who used incentive options to buy stock that dropped significantly by the end of the tax year, but only if the shares were sold before the end of the year).

⁹³ See *id.* “Wash sale” rules disallow a loss sustained upon a sale or other disposition of securities if, during the period beginning thirty days prior to the sale date and ending thirty days after the sale date, the taxpayer acquires new securities substantially identical to securities that had been sold. I.R.C. § 1091(a); Treas. Reg. § 1.1091-1 (as amended in 1967).

⁹⁴ Because the employee sold her ISO shares in a disqualifying disposition, the stock does not qualify for ISO treatment. I.R.C. §§ 421(a), 422. Therefore, the regular income tax system applies to the exercise, and the bargain purchase income as of the date of exercise is subject to tax as ordinary income. *Id.* §§ 83, 1091. In this situation, the loss is not recognizable and cannot offset the bargain purchase income realized as of the date of exercise. *Id.* §§ 56(b)(3), 422(c)(2); see also Reicher et al., *supra* note 7, at A10.

⁹⁵ See Weston et al., *supra* note 13 (describing Jeffrey and Cindy Chou’s 2000 AMT disaster); Donmoyer, *supra* note 10 (describing Jeffrey Chou’s \$1.9 million AMT debt and financial ruin).

had sold their Cisco shares for thirty-seven dollars before the end of 2000, they would have had a disqualifying disposition because the ISO shares would not have been held for at least one year after exercise or two years from the grant of the option. They no longer would have been liable for AMT on \$7 million in bargain purchase income. Rather, they would have been required to recognize as ordinary income the lesser of the bargain purchase income at the date of exercise (\$7 million) or the excess of the sales proceeds over their adjusted basis in the shares sold (\$3.7 million). By choosing the latter option, they could have greatly reduced their tax liability. If they had understood that selling their shares before the end of 2000 would have saved so much money, they could have avoided the AMT and reduced their federal income tax bill by at least \$500,000.⁹⁶

If, however, the Chous had reacquired their Cisco shares within 30 days of the disqualifying disposition (30 days before or 30 days after), they would not be able to reduce their gross income.⁹⁷ Rather, the entire amount of the bargain purchase income (\$7 million) would be included in gross income and subject to tax as ordinary income. The resulting regular income tax would be approximately \$2.8 million (\$7 million x 39.6%). While the Chous' actual 2000 tax liability under the AMT was significant (\$2 million), it was less than what the tax consequences would have been had they sold their Cisco shares in a disqualifying disposition and reacquired them in a "wash sale" (\$2.8 million).⁹⁸

In summary, the Chous' tax liability would have varied greatly depending on whether and when they sold their shares, as well as whether they sold them in a wash sale. Because the Chous exercised their options during the exuberant markets of 2000, they had to pay \$2 million in AMT. If they had sold their shares by the end of 2000 for thirty-seven dollars per share, then the sale would have been a disqualifying disposition, the regular income tax system would have applied, and the Chous would have paid only \$1.5 million of regular income tax. If, however, the Chous reacquired their shares in a wash sale, then the resulting regular income tax would have been \$2.8 million.

A fourth alternative for the Chous would have been to exercise their ISOs shortly after their grant date, when their exercise price of five to ten cents per share was equal to the fair market value of the ISO stock.⁹⁹ This would have resulted in zero bargain purchase income, zero AMT, and zero regular income tax. Along with the reduced tax liability, the incentive aspect of the ISOs would not have decreased, since the Chous would

⁹⁶ \$1.5 million in ordinary income tax (\$3.7 million x 39.6%) as compared with \$2 million in AMT (\$7 million x 28%). See Weston et al., *supra* note 13.

⁹⁷ See *supra* notes 93–94 and accompanying text.

⁹⁸ See I.R.C. §§ 422(c)(2), 1091(a).

⁹⁹ An employer must grant ISOs with an exercise price not less than the fair market value of the stock on the date of grant. *Id.* § 422(b)(4).

have to hold their Cisco shares for two years from the date of the grant to receive favorable ISO tax benefits. Accordingly, the Chous still could have profitted from the long-term effects of their contributions to Cisco. If the Chous choose to sell their Cisco shares at any time after the ISO statutory holding period, any appreciation realized above their insignificant cost basis would be subject to tax at favorable long-term capital gains tax rates.

The Chous' fact pattern demonstrates that taxpayers can plan their transactions to minimize their overall tax costs, including eliminating AMT. However, tax planning requires an understanding of the tax laws before consummating transactions. Because the AMT system is so complicated and intricate, most AMT-payers seek professional tax assistance to prepare their tax returns.¹⁰⁰ As demonstrated by the Chous' situation, tax planning for ISO transactions must occur well before the preparation of tax returns.

d. Disqualifying Disposition and Exercise in Different Tax Years

If a shareholder exercises her ISO in one year, but then sells her shares in a disqualifying disposition in a later tax year, the regular tax and AMT consequences are different, and the employee might be subject to AMT in the year of the ISO exercise. Under the regular income tax system, there are no tax consequences in the year of the ISO exercise.¹⁰¹ Under the AMT system, the shareholder must recognize the bargain purchase income as a positive AMT adjustment in the year of exercise and, therefore, might owe AMT.¹⁰²

In the year of the disqualifying disposition of the ISO shares, the shareholder must recognize the bargain purchase income in her gross income for regular income tax purposes.¹⁰³ In addition, any increase in value of the stock realized after the date of exercise is capital gain.¹⁰⁴ The shareholder's capital gain will be long-term if the shareholder held the shares for more than one year after the date of exercise, and short-term if the holding period was one year or less.¹⁰⁵

¹⁰⁰ Shaviro, *supra* note 30, at 1457 (stating that almost 93% of taxpayers with AMT liability used paid tax preparers).

¹⁰¹ I.R.C. §§ 422, 421(a).

¹⁰² *Id.* §§ 56(b)(3), 55.

¹⁰³ *Id.* § 83. Because the option has failed to qualify as an ISO, the Code provides that the exercise of the option is treated as any other transfer of property for services. *Id.* Accordingly, the employee must include in gross income the excess of the fair market value of the stock as of the date of exercise over the amount paid for the stock, if any, in the taxable year in which the disqualifying disposition occurred. *Id.* §§ 83, 421(b); *see also* Reicher et al., *supra* note 7, at A9. If the shares are sold for an amount less than the fair market value of the shares on the date of exercise, then the amount of bargain purchase income is limited to any gain realized. I.R.C. § 422(c)(2).

¹⁰⁴ I.R.C. § 1001(a).

¹⁰⁵ *Id.* § 1222.

The bargain purchase income that is recognized for regular income tax purposes in the year of the disqualifying disposition will not be recognized for AMT purposes.¹⁰⁶ Under the AMT system, the bargain purchase income is recognized in the year of exercise and, therefore, is not included again in the year of the disqualifying disposition.¹⁰⁷ Therefore, regular taxable income must be reduced by any recognized bargain purchase income to derive AMTI.¹⁰⁸ Additionally, under the AMT system, the basis of the ISO stock sold includes the bargain purchase income recognized in the year of exercise.¹⁰⁹ Any gain or loss recognized on the disqualifying disposition for AMT purposes is computed using the higher AMT stock basis.¹¹⁰ As a result of these reductions to an employee's regular taxable income to derive AMTI, the employee's regular income tax should be greater than the employee's AMT.¹¹¹ The employee can use her AMT credit (that is, any AMT taxes paid in a prior tax year with respect to her ISO exercise) to reduce her regular tax liability to her AMT.¹¹² The employee can carry any AMT credit not used forward to future tax years indefinitely to reduce her regular tax liability to her AMT.¹¹³

The Chous' situation illustrates how tax liability changes when the exercise and disqualifying sale take place in different years. In 2000, the Chous will have a positive AMT adjustment equal to \$7 million (the bargain purchase income) and a year 2000 AMT bill of \$2 million.¹¹⁴ If the Chous sold their ISO shares of Cisco in an April 2001 disqualifying disposition for \$18 per share, they would have to recognize ordinary income of approximately \$1.8 million.¹¹⁵ For 2001 AMT purposes, the Chous would be able to reduce their taxable income by \$1.8 million to offset the \$1.8 million bargain purchase income included in regular taxable income from their stock sale.¹¹⁶ They also would have a \$5.2 million capital loss, consisting of the \$7 million AMT basis in Cisco shares, minus the \$1.8 million realized from the sale.

Unfortunately, because the disqualifying disposition would not have occurred in the same tax year as the exercise, a complete offset of the

¹⁰⁶ See David R. Wenzel, *Incentive Stock Options: Impact of Disqualifications, Interaction with AMT Credit*, 22 TAX ADVISER 435 (1991) (noting that in the year of disqualifying disposition the taxpayer will have to make a negative adjustment to taxable income to compute her AMTI and that the applicable tax forms do not provide for such an adjustment).

¹⁰⁷ See H.R. REP. NO. 100-795, at 90 (1988).

¹⁰⁸ See Wenzel, *supra* note 106.

¹⁰⁹ I.R.C. § 56(b)(3).

¹¹⁰ *Id.*

¹¹¹ See, e.g., *infra* notes 114–123 and accompanying text.

¹¹² I.R.C. § 53(c).

¹¹³ *Id.*

¹¹⁴ See *supra* note 95 and accompanying text.

¹¹⁵ \$1,800,000 (\$18 x 100,000) less \$5,000 (5 cents (exercise price) x 100,000). See I.R.C. § 422(c)(2).

¹¹⁶ See Wenzel, *supra* note 106.

loss on the stock since the date of exercise against the bargain purchase income is not available for AMT purposes.¹¹⁷ As in the regular income tax system, the \$5.2 million capital loss under the AMT system could not be carried back to prior tax years and would be limited on an annual basis to recognized capital gains plus \$3,000 per tax year.¹¹⁸ Therefore, unless the Chous had a \$5.2 million AMT capital gain, in 2001 they could use only part of their entire \$5.2 million AMT capital loss. Any portion of the AMT capital loss that remains unused could be carried forward indefinitely to subsequent tax years to reduce the Chous' AMT capital gains plus up to \$3,000 of their AMTI.¹¹⁹

As a result of the negative AMT adjustment of \$1.8 million and their AMT capital loss, the Chous' 2001 AMTI would be significantly less than their regular taxable income. Assuming that the Chous' other items of taxable income equal their allowable deductions, the Chous' 2001 regular taxable income would be \$1.8 million of ordinary income due to their disqualifying disposition of Cisco stock. The Chous' 2001 regular income tax liability would be approximately \$700,000.¹²⁰ Assuming that the Chous have no AMT capital gains or other AMT adjustments, their 2001 AMTI would be zero and their 2001 AMT would also be zero.¹²¹ The Chous could use \$700,000 of their \$2 million AMT credit (resulting from their 2000 AMT) against their regular income tax liability and pay zero tax in 2001.¹²² The balance of their AMT credit of \$1.3 million would be carried forward indefinitely to subsequent tax years to reduce the Chous' regular tax liability to—but not below—their AMT for those years.¹²³

¹¹⁷ See I.R.C. § 56(b)(3).

¹¹⁸ *Id.* § 1211(b); see Kurt Heinrichson et al., *Revisiting ISOs With 24% AMT*, 22 TAX ADVISER 151, 152 (1991).

¹¹⁹ See I.R.C. §§ 1211(b), 56(b)(3).

¹²⁰ \$1.8 million x 39.1% = \$700,000. See *id.* § 1(i)(2) (setting forth reduced tax rates for taxpayers for tax year 2001).

¹²¹ The Chous would reduce their regular taxable income of \$1.8 million by \$1.8 million (bargain purchase income) plus \$3,000 capital loss recognized resulting in AMTI of zero. See *id.* § 55(b)(2). Tentative minimum tax would also be zero. See *id.* § 55(b)(1). The Chous would have an AMT capital loss carryforward of \$5.197 million (\$5.2 million realized loss less \$3,000 recognized loss), which they could offset against recognized AMT capital gains plus AMTI up to \$3,000 per tax year. See *id.* §§ 56(b)(3), 1211(b).

¹²² See *id.* § 53(c).

¹²³ See *id.* The Chous' AMT credit carryforward of \$1.3 million would be available in subsequent tax years to reduce their regular tax liability to their AMT. Because the Chous have a \$5.197 million AMT capital loss carryforward from the sale of their Cisco stock (and no regular income tax capital loss carryforward), they would have a negative adjustment to their regular taxable income of at least \$3,000 per tax year (plus any offset against recognized capital gains) to derive their AMTI. See *id.* § 1211(b). This might result in a slightly lower annual AMT relative to their regular tax liability (\$780, or \$3,000 multiplied by the lowest AMT tax rate, which is 26%). See *id.* § 55(b)(1)(A)(i)(I). Therefore, the Chous might be able to reduce minimally their regular income tax liability to their AMT. Unless the Chous are able to generate AMT capital gains, they might have to use their \$1.3 million AMT credit carryforward (\$1.3 million divided by \$780 per year) and

As one can see from the foregoing scenarios, the tax consequences of a disqualifying disposition of ISO stock where the exercise and sale occur in different tax years are complicated. In all cases, the total amount of income recognized in the year of sale for regular income tax purposes is greater than or equal to the amount recognized for AMT.¹²⁴ This occurs because, for AMT purposes, any bargain purchase income was recognized previously in the year of the ISO exercise. Comparatively, if the disqualifying disposition occurs in the same tax year as the exercise, the total amount of income recognized is the same for regular income taxes and under the AMT.

If the disqualifying disposition and exercise occur in different tax years, any recognized gain or loss for AMT purposes from the disqualifying sale is capital gain or loss.¹²⁵ Because AMTI might be lower than regular taxable income, AMT might be lower than regular income tax in the year of disqualifying sale. Any AMT paid as a result of ISO exercises can be offset as an AMT credit against regular income tax to reduce it to the lower AMT. Any excess AMT credit can be carried forward indefinitely to reduce regular income tax to AMT. Excess AMT credit and AMT capital loss carryforwards will likely result if AMT capital losses are significant and limited.

C. The Non-Tax Favored Sister to ISOs: NQSOs

1. What Is an NQSO?

An NQSO (non-qualified stock option) is any compensatory option that does not satisfy the statutory requirements for characterization as an ISO and tax-favored treatment.¹²⁶

2. Tax Treatment of an NQSO

a. Grant of an NQSO

Because NQSOs do not satisfy the requirements for tax-favored treatment, they are subject to the tax provisions applicable to transfers of property in connection with the performance of services.¹²⁷ Therefore,

\$5.197 million capital loss carryforward (\$5.197 million divided by \$3,000 per year) over the next 1700 or so tax years (that is, assuming no changes in the Code).

¹²⁴ If ISOs are exercised when the bargain purchase income is zero, then the total amount of income recognized in the year of sale for regular income tax purposes and for AMT will be the same.

¹²⁵ The capital gain is long-term if the employee has held her ISO shares for more than one year after exercise.

¹²⁶ Options that do not qualify under I.R.C. § 421 are non-qualified stock options (NQSOs). As a result, NQSOs are subject to tax under I.R.C. § 83.

¹²⁷ See I.R.C. § 83.

unless the NQSO has a readily ascertainable fair market value at the time of the grant,¹²⁸ the grant of the NQSO is not a recognition event; as with a grant of an ISO, the grant itself does not constitute a transfer of property.¹²⁹

b. Exercise of an NQSO

When an employee exercises an NQSO she must recognize as ordinary income the bargain purchase income of the NQSO (that is, the positive difference between the fair market value of the stock at the date of exercise and the exercise price paid, if any).¹³⁰ This income is subject to employee withholdings and regular income and payroll taxes.¹³¹ Any amount recognized as ordinary income is added to the amount paid for the shares to determine the shareholder's tax basis.¹³² The holding period for the shares acquired begins on the day after the exercise.¹³³

There are no AMT consequences for the exercise of an NQSO because all of the economic income has already been included in the employee's regular income.

c. Disposition of NQSO Stock

When a shareholder sells her shares of stock acquired through the exercise of NQSOs, the general rules applicable to any sale of a capital asset dictate the tax consequences.¹³⁴ The shareholder recognizes capital gain or loss equal to the difference between the amount realized from the sale and the adjusted basis in the shares sold.¹³⁵ Capital gain or loss is long-term or short-term depending upon how long the shareholder held the shares after her exercise.¹³⁶ The capital loss limitations¹³⁷ and the favorable capital gains tax rates apply.¹³⁸

Employees holding NQSOs often defer exercising as long as possible because publicly traded stocks have historically increased in value over time. By waiting, the holder of the NQSO benefits from the stock appreciation without investing any cash to exercise the option. At the same time, the holder has avoided the investment risk if the stock price

¹²⁸ See Treas. Reg. § 1.83-7(a) (1978).

¹²⁹ See Treas. Reg. § 1.83-3(a) (as amended in 1985).

¹³⁰ I.R.C. § 83(a).

¹³¹ See Treas. Reg. § 1.83-1 (1978).

¹³² I.R.C. § 1012.

¹³³ See Rev. Rul. 66-7, 1966-1 C.B. 188.

¹³⁴ See I.R.C. § 1001.

¹³⁵ *Id.* § 1001(a).

¹³⁶ See *id.* § 1222.

¹³⁷ See *supra* note 26 and accompanying text.

¹³⁸ See I.R.C. § 1(h) (applying a maximum tax rate of 20% on sales of appreciated stock held for more than one year as a capital asset).

should decline. However, this deferral of exercise will cause a greater amount of income to be subject to ordinary income and payroll taxes upon exercise. If the employee holds the shares for more than one year, the appreciation after exercise will be subject to tax at favorable long-term capital gain tax rates.¹³⁹ If, however, the holder exercises the NQSOs as soon as possible, then, provided that the stock value increases over time, she will minimize the bargain purchase income that is subject to ordinary income and payroll taxes and maximize any favorable tax treatment of long-term capital gains. Because the amount of income characterized as ordinary income is the excess of the fair market value (as of the date of exercise) over any amount paid, if the holder exercises as soon as possible, the fair market value will be at its lowest and any ordinary income will be a smaller amount than if she had exercised at a later date.¹⁴⁰ Any subsequent appreciation recognized more than one year after exercise will be characterized as long-term capital gain, subject to favorable tax rates.

III. THE PERVASIVE AMT PROBLEM

Academic and practitioner groups as well as the Internal Revenue Service and National Taxpayer Advocates have called for repeal or simplification of the AMT.¹⁴¹ Many people agree that the AMT is too complicated¹⁴² and that its current and expanding impact is no longer consistent with Congress's purpose in enacting it. There is bipartisan support

¹³⁹ *Id.*

¹⁴⁰ For example, Employer grants Employee 100 NQSOs with an exercise price of \$10 when the fair market value of the stock is \$15. Employee exercises her NQSOs one month after the grant when the fair market value of the stock has increased to \$16. Employee must recognize \$600 of ordinary income (\$16 fair market value as of the date of exercise less \$10 paid = \$6 x 100 shares), subject to ordinary income and payroll taxes. Assume the stock price increases to \$100 during the next eighteen months. If Employee sells her stock, she will recognize \$8,400 of long-term capital gain (\$10,000 sales price less \$1,600 (\$1,000 paid + \$600 bargain purchase income) adjusted basis in shares), subject to maximum long-term capital gain tax rate of 20%. *Id.* § 1(h). If, however, Employee waits to exercise her NQSOs until the stock price reaches \$100 and immediately sells the shares, she will have to recognize \$9,000 as ordinary income (\$100 fair market value less \$10 paid = \$90 x 100 shares), subject to ordinary income and payroll taxes, and no capital gain (\$10,000 sales price less \$10,000 (\$1,000 paid + \$9,000 bargain purchase income) adjusted basis in shares).

¹⁴¹ Hamilton, *supra* note 29 (National Taxpayer Advocate Olson recommends that Congress repeal the individual AMT); see Annual Report from the Commissioner of the Internal Revenue Service on Tax Law Complexity, June 5, 2000; Ryan J. Donmoyer, *NAEA Says AMT Is Biggest Tax Headache of All*, 87 TAX NOTES 42 (2000); William G. Gale, *Tax Simplification: Issues and Options*, 92 TAX NOTES 1463 (2001); Sheryl Stratton, *Oveson Speaks Out on Tax Code Complexity*, 88 TAX NOTES 1177, 1199 (2000) (former National Taxpayer Advocate W. Val Oveson calls for the repeal of the AMT).

¹⁴² Shaviro, *supra* note 30, at 1457–58 (noting that the AMT adds to “transactional complexity” and “rule complexity,” that taxpayers spent over 29 million hours annually completing and filing the AMT tax form, and that more than 10% of tax returns with AMT had errors in the AMT calculation).

for AMT reform.¹⁴³ Democratic and Republican members of Congress from more than twenty-five states have cosponsored various bills to simplify, minimize, or even repeal the AMT.¹⁴⁴

In lieu of AMT repeal, which would cost over \$600 billion in lost revenue through 2011,¹⁴⁵ critics have made numerous recommendations for AMT reform. While these amendments do not include elimination of the ISO exercise AMT adjustment, they nonetheless would minimize AMT costs for ISO exercisers.¹⁴⁶ They would do this by potentially reducing AMTI through larger exemption amounts and additional deductions.¹⁴⁷ This Part will discuss a number of the most commonly proposed AMT amendments: indexing for inflation; eliminating AMT adjustments for state and local taxes; and eliminating AMT adjustments for personal and dependency deductions. Academics and practitioners have made additional recommendations for reform, including elimination of the AMT adjustments for the standard deduction and miscellaneous itemized deductions.¹⁴⁸ In addition, a strong grassroots movement is developing in favor of AMT relief for certain ISO exercisers. Notwithstanding, the three modifications discussed here should vastly simplify the AMT and significantly reduce the number of AMT taxpayers. Under these propos-

¹⁴³ Margo Thorning, *Policy Briefs: ACCF Research Center Reports on AMT*, 67 TAX NOTES 1425 (1995) (mentioning that AMT reform has bipartisan support and that Presidents Bush and Clinton proposed changes to the AMT).

¹⁴⁴ See Active Legislation, at <http://www.reformamt.org/legislation.php> (last visited Mar. 26, 2002). On April 4, 2001, Representative Zoe Lofgren sponsored a bill in the House of Representatives, H.R. 1487, which would repeal the AMT adjustment for ISO exercises in 2000 and thereafter. See 147 CONG. REC. H1487 (daily ed. Apr. 4, 2001). As of March 2002, H.R. 1487 had 58 cosponsors (35 Democrats and 23 Republicans representing 22 states). See Sponsorship of H.R. 1487, at <http://www.kls2.com/cgi-bin/hrspon?bill=hr1487> (last visited Mar. 26, 2002).

¹⁴⁵ Bennett, *supra* note 19 (stating estimates from Jerry Tempalski, an economist with the Treasury Department's Office of Tax Analysis, that repealing the AMT after enactment of the Economic Growth and Tax Relief Reconciliation Act of 2001 ("EGTRRA"), Pub. L. 107-16, 115 Stat. 38, would cost \$600 billion in lost revenue from 2002 through 2011 and would cause 35.1 million taxpayers (33% of all taxpayers) to owe AMT in 2010). Estimates of the tax revenue costs before enactment of EGTRRA, Pub. L. No. 107-16, 115 Stat. 38 (2001), were \$200 billion from 2001 through 2010. See Martin A. Sullivan, *Needed But Not Wanted: \$200 billion of AMT Relief*, 88 TAX NOTES 724, 726 (2000).

¹⁴⁶ Under the current AMT, taxpayers must add back any deductions for state and local taxes and personal and dependency exemptions to compute their AMTI. I.R.C. §§ 55(b)(2), 56(b)(1)(A)(ii), 56(b)(1)(E). Under the proposed AMT reforms, ISO exercisers would not have to increase their taxable income by their state and local tax deductions and personal and dependency exemptions to determine their AMTI. Additionally, ISO exercisers would compute their AMT by using increased exemption amounts and tax rates indexed for inflation, which would reduce any AMT. See *infra* Part III.C. (discussing proposed model reforms for the AMT).

¹⁴⁷ See *infra* Part III.C.

¹⁴⁸ See Shaviro, *supra* note 30, at 1464-65 (describing proposed elimination of the AMT adjustments for the standard deduction, medical deductions, and miscellaneous itemized deductions); Hamilton, *supra* note 29 (noting that Olson recommends that, if Congress does not repeal the AMT, it should eliminate the standard deduction, deductible state and local taxes, personal exemptions, and miscellaneous itemized deductions as AMT adjustments).

als, the AMT would become more transparent, allowing taxpayers to plan their transactions in accordance with their economic goals.

A. *ReformAMT.com*

Shocked and stripped of jobs, investment and retirement value, and other savings, a large number of former dot.com employees have joined together in a grassroots organization called ReformAMT. The group's mission, stated on its Web site, "is to correct an injustice created by the way in which the Alternative Minimum Tax (AMT) is inappropriately and unjustly imposed upon owners of incentive stock options."¹⁴⁹ ReformAMT's mission is: (1) to lobby the government to reform AMT treatment of employee stock options and to provide retroactive relief to affected employees; and (2) to educate the public about, and build support for the reform of, the AMT's treatment of employee stock options.¹⁵⁰ ReformAMT also serves as a support group for taxpayers affected by the AMT's treatment of employee stock options.¹⁵¹

The popular perception of stock options as perks for the wealthy belies the reality that the AMT has financially ruined many ISO exercisers, especially those of more moderate means. The ReformAMT Web site includes stories of members' AMT disasters. For example, consider the following "Real-Life AMT victim":¹⁵²

Norma Mogilefsky, 59, grew up in New York, has a master's degree in special education, and currently works as a curriculum developer at a software company. She is a single mom with two grown children. Throughout her life, she worked hard to raise her family, pay the bills, and build perfect credit. She hoped to retire in June.

Last spring, on the advice of a recommended enrolled agent, Norma took out a second loan against her home for \$80,000 so she could purchase her incentive stock options (ISOs), and then hold them for a year. This, the agent advised, would put her into a long-term capital gains tax bracket, which was the prudent thing to do. The agent never mentioned the potential for an Alternative Minimum Tax (AMT) disaster. He also did not speak with Norma again until the day that he did her taxes.

¹⁴⁹ <http://www.ReformAMT.com> (last visited Mar. 20, 2002). In March 2002, ReformAMT had about 1591 members. See ReformAMT Geographic Membership, at <http://www.kls2.com/reformamt/geomembers.html> (last visited Mar. 20, 2002).

¹⁵⁰ See About ReformAMT, at <http://www.reformamt.org/about.php> (last visited Feb. 24, 2002).

¹⁵¹ See Real-Life AMT Victims, at <http://www.reformamt.org/stories.php> (last visited Feb. 24, 2002).

¹⁵² *Id.*

Her company, meanwhile, sent an e-mail to its employees on April 2, recommending that those who exercised ISOs in 2000 might be subject to AMT, and should seek professional advice immediately. It was too late. On April 15, 2001, Norma owed a tax bill of \$303,000, three times her annual salary, on paper profits she never saw.¹⁵³

ReformAMT has rallied a large group of “real-life AMT victims” and sympathetic allies to educate Congress and the public about its goal of eliminating AMT liability for the exercise of ISOs in year 2000 and thereafter. The list of legislators who have supported AMT reforms includes Senators Joseph Lieberman (D-Conn.), Tom Harkin (D-Iowa), Wayne Allard (R-Colo.), John Kerry (D-Mass.), and Barbara Boxer (D-Cal.),¹⁵⁴ as well as almost fifty members of the House of Representatives.¹⁵⁵ In August 2001, Senator Lieberman and Congressman Richard E. Neal (D-Mass.) introduced identical bills in the Senate and the House that potentially would eliminate the AMT for taxpayers who exercised their ISOs in 2000.¹⁵⁶ The bills would provide a one-time fix for taxpayers who were subjected to the AMT due to their 2000 exercise of ISOs and whose stock experienced significant post-exercise declines in value. The bills, which have a cost of \$1.3 billion over ten years,¹⁵⁷ have been referred to the House Ways and Means Committee and the Senate Committee on Finance.¹⁵⁸ More recently, in the October 24, 2001 House of Representatives mark-up of the “Economic Security and Recovery Act of 2001,” the House considered, but rejected, a proposal by Representative Charles B. Rangel (D-N.Y.), to eliminate year 2000 and 2001 ISO exercises from normal AMT treatment.¹⁵⁹

¹⁵³ *Id.*

¹⁵⁴ On August 2, 2001, Senator Lieberman sponsored a bill to grant AMT relief to those who exercised ISOs in 2000. S. 1324, 107th Cong. (2001); 147 CONG. REC. S8704 (daily ed. Aug. 2, 2001). Senators Harkin, Kerry, Boxer, and Allard became cosponsors between October and December 2001. *See* 147 CONG. REC. S10457 (daily ed. Oct. 10, 2001); 147 CONG. REC. S11549 (daily ed. Nov. 7, 2001); 147 CONG. REC. S11940 (daily ed. Nov. 15, 2001); 147 CONG. REC. S12682 (daily ed. Dec. 7, 2001).

¹⁵⁵ Forty-seven representatives cosponsored a House bill granting AMT relief. *See* H.R. 2794, 107th Cong. (2001), available at <http://thomas.loc.gov/bss/d107/d107bill.html> (last visited Feb. 24, 2002).

¹⁵⁶ The bills would limit AMT liability for those who exercised ISOs in 2000 by calculating income using the stock value on April 15, 2001 or the amount realized if the stock was sold, rather than its value on the exercise date. *See* H.R. 2794, 107th Cong. (2001); S. 1324, 107th Cong. (2001).

¹⁵⁷ *See Lieberman Bill Would Provide AMT Relief for Incentive Stock Options*, 92 TAX NOTES 1196, 1196–97 (2001) (stating that the Joint Committee on Taxation estimates that the bill would reduce revenues by \$1.3 billion over ten years).

¹⁵⁸ *See* 147 CONG. REC. H5336 (daily ed. Aug. 2, 2001); 147 CONG. REC. S8704 (daily ed. Aug. 2, 2001).

¹⁵⁹ The Rangel Amendment failed (166–261) on a mostly party-line vote, with forty-three Democrats voting with Republicans. *See* 147 CONG. REC. H7279–80 (daily ed. Oct.

B. *The AMT: A Pervasive and Expensive Problem*

The AMT has been the subject of concern and controversy since its enactment as a minimum tax in 1969.¹⁶⁰ Many academic and practitioner groups as well as the Internal Revenue Service and National Taxpayer Advocates are calling for its repeal or simplification.¹⁶¹ The Economic Security and Recovery Act of 2001, which was adopted by the House of Representatives on October 24, 2001, contained a provision that would repeal the corporate AMT.¹⁶² The Joint Committee on Taxation estimated that this provision would cost approximately \$24 billion through 2011.¹⁶³ Critics called the potential repeal of the corporate AMT a windfall for corporate bankrolls.¹⁶⁴

24, 2001). The text of the amendment was as follows:

SEC. 131. ALTERNATIVE MINIMUM TAX RELIEF WITH RESPECT TO INCENTIVE STOCK OPTIONS EXERCISED DURING 2000.

In the case of an incentive stock option (as defined in section 422 of the Internal Revenue Code of 1986) exercised during calendar year 2000 or 2001, the amount taken into account under section 56(b)(3) of such Code by reason of such exercise shall not exceed the amount that would have been taken into account if, on the date of such exercise, the fair market value of the stock acquired pursuant to such option had been—

(1) its fair market value as of—(A) April 15, 2001, in the case of options exercised during 2000, and (B) December 31, 2001, in the case of options exercised during 2001, or

(2) if such stock is sold or exchanged on or before the applicable date under paragraph (1), the amount realized on such sale or exchange.

147 Cong. Rec. H7261 (daily ed. Oct. 24, 2001). The Rangel Amendment or a variation thereof might appear in new tax bills. *See, e.g.*, 148 Cong. Rec. S106 (daily ed. Jan. 24, 2002) (submission by Senator Kerry of a variation on the Rangel amendment).

¹⁶⁰ Congress enacted the statutory ancestor of the AMT as part of a broad tax reform in 1969. Tax Reform Act of 1969, Pub. L. No. 91-172, 83 Stat. 487.

¹⁶¹ *See* Annual Report from the Commissioner of the Internal Revenue Service on Tax Law Complexity, *supra* note 141; Donmoyer, *supra* note 141; Gale, *supra* note 141; Stratton, *supra* note 141 (noting that former National Taxpayer Advocate W. Val Oveson emphasized repeal of the AMT, which he described as “absolutely, asininely stupid”); Sheryl Stratton, *Taxpayer Advocate Addresses 9/11 Relief, Offers in Compromise*, 93 TAX NOTES 471 (2001).

¹⁶² H.R. 3090, 107th Cong., § 103 (2001). The provisions were rejected by the Senate in late 2001, when the Committee on Finance reported out an amendment in the nature of a substitute that failed to include any provisions for repeal of the corporate AMT. *See* 147 CONG. REC. S11678–11696 (daily ed. Nov. 13, 2001); Bill Summary and Status for 107th Congress, H.R. 3090, at <http://thomas.loc.gov/bss/d107/d107bill.html> (last visited Apr. 17, 2002).

¹⁶³ *See* J. COMM. ON TAXATION, 107TH CONG., ESTIMATED BUDGET EFFECTS OF A MODIFIED CHAIRMAN’S AMENDMENT IN THE NATURE OF A SUBSTITUTE TO THE REVENUE PROVISIONS CONTAINED IN H.R. 3090, THE “ECONOMIC SECURITY AND RECOVERY ACT OF 2001,” JCX-70-01 (Comm. Print 2001).

¹⁶⁴ Warren Rojas, *Corporate AMT Repeal Strikes a Chord with Democrats, Critics*, 93 TAX NOTES 455 (2001) (noting that IBM would receive \$1.4 billion, General Motors \$833 million, General Electric \$671 million, ChevronTexaco \$572 million, Enron \$254 million, American Airlines \$184 million, and Comdisco \$144 million).

While President George W. Bush “has incessantly prodded the Senate to pass the stimulus measure,”¹⁶⁵ the Senate rejected the bill, along with its proposed revisions to the AMT, in late 2001.¹⁶⁶ Debate on an economic stimulus package continued in early 2002, and, on March 9, 2002, President George W. Bush signed into law the Job Creation and Worker Assistance Act of 2002.¹⁶⁷ The new law does not make any changes to the existing individual AMT and makes only one temporary change to the corporate AMT.¹⁶⁸

Thus, the individual and corporate AMT continues to exist today. If Congress does not amend the AMT, it will impact an increasing number of taxpayers at an aggressive pace. The Joint Committee on Taxation estimates that, under current law, by 2010 thirty-five million taxpayers (approximately 33% of all individual taxpayers) will face the AMT.¹⁶⁹ There is overwhelming consensus that the AMT is no longer operating as Congress intended and that something must be done.¹⁷⁰ However, the notion of repealing the individual AMT has paralyzed members of Congress because the cost of eliminating the individual AMT is estimated at more than \$600 billion through 2011.¹⁷¹ Additionally, some members of Con-

¹⁶⁵ Janet Hook, *Stimulus Bill on Way to Its Death*, L.A. TIMES, Feb. 6, 2002, at A1.

¹⁶⁶ On November 13, 2001, the Committee on Finance introduced amended bill SA2125 (the Economic Recovery and Assistance for American Workers Act of 2001 proposed by Senator Max Baucus (D-Mont.)), which effectively replaced the “Economic Security and Recovery Act of 2001.” See 147 CONG. REC. S11678-11696 (daily ed. Nov. 13, 2001). On November 14, 2001, the Senate rejected the Economic Recovery and Assistance for American Workers Act of 2001. See 147 CONG. REC. S11,783 (daily ed. Nov. 14, 2001).

¹⁶⁷ Pub. L. No. 107-147, 116 Stat. 21.

¹⁶⁸ The Job Creation and Worker Assistance Act of 2002, among other things, provides for temporary relief from corporate net operating loss limitation under the AMT. 148 CONG. REC. S1661 (daily ed. Mar. 7, 2002). The Act also provides for special accelerated depreciation for certain assets acquired after September 10, 2001 and before September 11, 2004. *Id.* at S1660. To ensure that qualifying taxpayers will enjoy this tax benefit, the 2002 Act amends the AMT to provide that this deduction is allowable under the AMT system. *Id.*; see also Job Creation and Worker Assistance Act, § 101.

¹⁶⁹ See Bennett, *supra* note 19. Estimates of the tax revenue costs before enactment of EGTRRA, Pub. L. No. 107-16, 115 Stat. 38 (2001), were \$200 billion through 2010. See Gale, *supra* note 141, at 1469 (citing J. COMM. ON TAXATION, 107TH CONG., ESTIMATED REVENUE EFFECTS OF THE PRESIDENT’S FISCAL YEAR 2002 BUDGET PROPOSAL (2001)); see also Warren Rojas, *JCT Estimates Bush Tax Cut Would Double AMT Taxpayers*, 89 TAX NOTES 171 (2001).

¹⁷⁰ See Shaviro, *supra* note 30, at 1455-56 (stating that “[p]erhaps no rules in the Internal Revenue Code are so regularly featured on tax simplification hit lists as the individual and corporate alternative minimum taxes” and supporting his comment with reports calling for simplification from the ABA Tax Section, AICPA, Tax Executives Institute, National Association of Enrolled Agents, IRS, and a National Taxpayer Advocate); see also Hamilton, *supra* note 29; Stewart S. Karlinsky, *American Taxation Association Recommends Modifications to AMT*, 71 TAX NOTES 1167 (1996) (suggesting five changes to the AMT).

¹⁷¹ See Bennett, *supra* note 19. One estimate placed the cost of repealing the AMT prior to the enactment of the EGTRRA at \$162 billion. Warren Rojas, *Taxpayers Burned by AMT Look for Support*, 92 TAX NOTES 153, 154 (2001); see also *Economic Analysis—Like Gasoline on a Fire, House Bill Fuels AMT Problems*, in Readings in Federal Tax Policy,

gress are concerned that an absolute repeal of the AMT, which Congress originally enacted to ensure that high economic income taxpayers paid at least some income taxes, might not be good tax policy.¹⁷²

Considering the broad impact the AMT is fast imposing on millions of taxpayers, AMT reform (although probably not repeal) is very likely in the near future.¹⁷³ However, whether or not the AMT adjustment for an exercise of ISOs will be eliminated or even modified, as proposed in the ReformAMT-supported bills currently under consideration by congressional committees, is not clear. There are twenty-eight AMT preferences and adjustments. Three of these twenty-eight items account for over 90% (in dollar terms) of total AMT preferences: state and local tax deductions (54%), personal and dependency exemption deductions (23%), and miscellaneous itemized deductions above the 2% floor (20%).¹⁷⁴ The ISO adjustment accounted for 5% of all AMT preferences and adjustments in 2000 (\$1.9 billion of adjustments) and is estimated to account for only 1% of the total projected preferences and adjustments in 2010 (\$4.5 billion).¹⁷⁵ As compared to the AMT adjustments for state and local tax deductions, personal and dependency exemption deductions, and miscellaneous itemized deductions, the ISO adjustment does not and is not projected to represent a significant component of aggregate AMT adjustments.

C. Model Reforms

1. Index for Inflation

The primary reason for the increase in the number of taxpayers subject to AMT is that the AMT system fails to index for inflation.¹⁷⁶ The

available at www.tax.org/federal/Federal_Readings/freadmain.htm (last visited Oct. 27, 2001) (citing cost estimates for eliminating the AMT of \$242 billion under the Bush proposal or \$292 billion under H.R. 3; a modified version of the two plans was signed into law as the EGTRRA, Pub. L. No. 107-16, 115 Stat. 38, on June 7, 2001).

¹⁷² These members seek to avoid the loss of taxpayer confidence that would result if the system did not assess any tax on high-income individuals or entities. See J. COMM. ON TAXATION, 99th Cong., GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1986, JCS-10-87, at 432-33 (1987). "The ability of high-income taxpayers to pay little or no tax undermines respect for the entire tax system and, thus, for the incentive provisions themselves. In addition, even aside from public perceptions, Congress decided that it is inherently unfair for high-income taxpayers to pay little or no tax due to their ability to utilize tax preferences." *Id.*; see also Heidi Glenn et al., *Simplification and AMT: Costly and Anything But Simple*, 22 INSUR. TAX REV. 23, 24 (2002) (suggesting that while most members of Congress would support the idea of AMT repeal, they have consistently decided against doing anything because AMT serves a purpose in the tax system and to repeal it without otherwise dealing with these issues would revive them).

¹⁷³ See Shaviro, *supra* note 30, at 1456.

¹⁷⁴ ROBERT REBELEIN & JERRY TEMPALSKI, WHO PAYS THE INDIVIDUAL AMT?, OFFICE OF TAX ANALYSIS PAPER 87 (2000).

¹⁷⁵ *Id.* at Table 5.

¹⁷⁶ *Id.*

regular income tax system indexes many deductions,¹⁷⁷ deduction limits, and tax rate schedules¹⁷⁸ for inflation. Indexing is good policy because it prevents tax costs from increasing solely because inflated income outpaces fixed deductions and rates. Surprisingly, the AMT does not have an analogous inflation adjustment system, even though Congress intended that the two systems operate in a parallel manner. Over the years taxpayers have become increasingly likely to be subject to the AMT, not because of their artful manipulation of deductions and exclusions in the Code, but because their tentative minimum tax has not been adjusted for bracket creep while their regular tax has.¹⁷⁹

Indexing the exemption amounts, the phase-out thresholds, and the tax rate brackets for inflation from 1986 through 2000 would have reduced the number of tax returns subject to AMT in 2000 from 1.3 million to 300,000.¹⁸⁰ For 2010, the projected effect would reduce the number of returns subject to AMT from 17 million to 300,000.¹⁸¹ Because the AMT rate brackets would be adjusted and a larger exemption amount would be allowed under an indexed AMT system, many ISO exercisers no longer would be subject to AMT if the law were amended to include inflation indexing.¹⁸²

Unfortunately, the cost of indexing the exemption amount, the phase-out thresholds, and the tax rate brackets to 2001 levels is a staggering \$370 billion from 2002 through 2011.¹⁸³ This cost may be worthwhile, however, to prevent the number of taxpayers subject to AMT from increasing until the AMT effectively replaces the regular income tax system.¹⁸⁴ By 2010, one out of three taxpayers, or more than 35 million

¹⁷⁷ See, e.g., I.R.C. §§ 63(c)(4) (indexing the standard deduction amounts) and 151(d)(4) (indexing personal and dependency exemption amounts).

¹⁷⁸ *Id.* § 1(f).

¹⁷⁹ See Shaviro, *supra* note 30, at 1456 (stating that from 1996 to 1998, the number of AMT taxpayers rose from 480,000 to 828,000, which is a 72.5% increase). Bracket creep occurs when inflation lifts a person's taxable income into a higher tax bracket or increases income relative to allowable deductions. The net result is stagnant purchasing power with an increase in income tax payable.

¹⁸⁰ REBELEIN & TEMPALSKI, *supra* note 174, at Table 1.

¹⁸¹ *Id.* Note that this information does not include the AMT impact of the Economic Growth and Tax Relief Reconciliation Act of 2001, which is expected to increase the number of AMT taxpayers in 2010 to 35 million. See Bennett, *supra* note 19 (citing Tempalski's estimate that indexing the AMT at 2001 levels would reduce the number of AMT payers by about 10 million in 2005 and 20 million in 2009).

¹⁸² If Congress indexes the AMT exemption, phase-out levels, and the tentative minimum tax calculation for inflation, then the exemption amount will be approximately \$70,000 (increased from \$45,000), and the tentative minimum tax will be 26% on the first \$208,000 (increased from \$175,000) of taxable excess and 28% on any amount of excess over \$208,000 (increased from \$175,000). See Shaviro, *supra* note 30, at 1463.

¹⁸³ See Bennett, *supra* note 19 (citing Tempalski's estimate). Prior to the enactment of the EGTRRA, Pub. L. No. 107-16, 115 Stat. 38 (2001), the estimated cost for indexing the AMT for inflation to 2000 levels was \$83.3 billion from 2001 through 2010. See Rebelein & Tempalski, *supra* note 174, at Table 2.

¹⁸⁴ See Graetz, *supra* note 39.

taxpayers, will owe AMT.¹⁸⁵ However, because the application of the AMT and its tax calculations are so complicated, most taxpayers are not aware that they may be subject to AMT or even that the AMT system exists.¹⁸⁶ This kind of stealth tax policy lacks transparency and destroys taxpayer confidence in the federal income tax system. Taxpayers are not likely to tolerate this type of policy, and, given the significant number and percentage of impacted taxpayers, their political outcry could eventually dwarf ReformAMT's grassroots efforts.¹⁸⁷

2. Eliminate AMT Adjustments for State and Local Tax Deductions

Taxpayers residing in high tax states such as California and New York might find themselves subject to AMT if they take large deductions for their state tax payments. The 2000 AMT adjustment for state and local itemized deductions was by far the largest adjustment item, accounting for 54% of all adjustments.¹⁸⁸ By 2010, as the AMT adjustment for personal and dependency exemptions increases at a relatively faster rate, the state and local tax deductions are projected to decrease, but still account for 44% of all AMT adjustments.¹⁸⁹ It is unreasonable that the current AMT regime effectively penalizes individuals for paying their state and local taxes. These payments actually reduce taxpayers' economic income. Moreover, they are legally enforceable taxpayer obligations, not artful or abusive manipulations of the Code.

Arguments can be made for and against state and local tax deductibility under any tax system.¹⁹⁰ Because taxes paid by an individual sometimes correlate with government-provided goods and services, and because these benefits are excluded from gross income, some argue that disallowing state and local tax deductions is a fair substitute for taxing

¹⁸⁵ See Bennett, *supra* note 19.

¹⁸⁶ Hamilton, *supra* note 29 (noting National Taxpayer Advocate Olson's comments that the AMT is so complicated, many taxpayers are not aware that they may be subject to it).

¹⁸⁷ ReformAMT and its 1591 members have done a commendable job of marshalling support from Congress. See <http://www.ReformAMT.com> (last visited Apr. 4, 2002); ReformAMT Geographic Membership, at <http://www.kls2.com/reformamt/geomembers.html> (last visited Mar. 20, 2002). With 35 million more voices, the campaign for AMT reform will be even stronger.

¹⁸⁸ REBELEIN & TEMPALSKI, *supra* note 174, at Table 5.

¹⁸⁹ *Id.* at 15 (determining that decline in percentage of state and local tax deductions will occur because taxpayers with several personal and dependency exemptions will comprise an increasing share of AMT taxpayers).

¹⁹⁰ See Shaviro, *supra* note 30, at 1465 (stating that the arguments against deductibility of state and local taxes have the upper hand in current academic debate and citing Louis Kaplow, *Fiscal Federalism and the Deductibility of State and Local Taxes Under the Federal Income Tax System*, 82 VA. L. REV. 413 (1996), opposing deductibility, and Brookes D. Billman & Noël B. Cunningham, *Nonbusiness State and Local Taxes: The Case for Deductibility*, 28 TAX NOTES 1107 (1985), favoring deductibility).

consumption of state or local government-provided goods and services.¹⁹¹ This argument might provide support for a change in the tax law to eliminate deductions for state and local taxes and the exclusion from taxable income of these goods and services for taxpayers in low or zero tax states. However, the current denial of state and local tax deductions under the AMT system causes taxpayers (including ISO exercisers) in high tax states to lose this material deduction, while not requiring taxpayers in low or zero tax states to include government-provided goods and services in their incomes. If members of Congress want to eliminate the deduction for state and local taxes and the exclusion of government-provided goods and services in low or zero tax states, the legislation should be straightforward and readily understandable by constituents. The complexity and lack of inflationary indexing in the AMT should not be used to obscure its disallowance of increasing state and local tax deductions for taxpayers in high tax states. Legislation that makes sweeping and significant changes should not be drafted to hide its purpose.¹⁹²

It is particularly arbitrary that ISO exercisers lose their state and local tax deductions merely because they realize economic income that makes them liable for AMT. If the state and local tax deduction is allowed under the AMT, fewer ISO exercisers will be subject to the AMT. To the extent that some ISO exercisers would remain subject to the AMT after deducting state and local tax payments, these individuals would receive fairer tax treatment because their AMT would result from their bargain purchase income in excess of any allowable exemption amount and not from the loss of their state and local tax deductions.

3. Eliminate AMT Adjustments for Personal and Dependency Deductions

Personal and dependency exemption deductions are allowed in the regular income tax system for taxpayers with adjusted gross income levels below certain threshold amounts.¹⁹³ These exemptions are not tax shelters or artful or abusive manipulations of the Code; rather, they are accepted tools for decreasing the tax liability of middle- and low-income taxpayers. Because these deductions are phased out at higher levels of income under the regular tax system,¹⁹⁴ high-income taxpayers generally

¹⁹¹ See Kaplow, *supra* note 190; see, e.g., I.R.C. § 265 (setting forth the rules for the denial of deduction for expenses and interest related to tax-exempt income).

¹⁹² See Shaviro, *supra* note 30, at 1457–58 (suggesting that “anyone who values transparency in the tax system—whether to improve monitoring by voters or to assist policy-makers in understanding what they are actually doing—has reason to consider the AMT highly objectionable”).

¹⁹³ I.R.C. § 151(d)(3).

¹⁹⁴ Note, however, that under the EGTRRA, Pub. L. No. 107-16, § 102, 115 Stat. 38 (codified at 26 U.S.C. § 151 (2001)), the phase-out of the personal and dependency exemptions is itself phased out over time beginning in 2006 through 2009. However, in 2010

do not benefit from personal and dependency exemptions. Thus, the regular income tax system already monitors the deductibility of personal and dependency exemptions, only allowing such deductions for middle- and low-income taxpayers. Therefore, the adjustment in the AMT system is redundant for high-income taxpayers, since they would not even receive the deductions under the regular income tax system.¹⁹⁵ To the extent that the AMT system is intended to target such high-paying taxpayers, adjustments for personal and dependency deductions are unnecessary because they currently benefit only middle- and low-income taxpayers.

IV. THE AMT ADJUSTMENT FOR ISO BARGAIN PURCHASE INCOME IS APPROPRIATE BECAUSE IT REPRESENTS ECONOMIC INCOME OTHERWISE EXCLUDED FROM TAXABLE INCOME

Congress intended that the AMT adjustment for the bargain purchase income from the exercise of ISOs limit the tax benefits ISO exercisers derive under the Code.¹⁹⁶ The bargain purchase income realized as a result of the ISO exercise is not included in regular taxable income, because the Code specifically excludes it.¹⁹⁷ An ISO exercise at a price below the fair market value of the stock, however, generates economic income for the employee. The employee has benefited from a bargain stock purchase, and, but for the ISO income exclusion provisions, she would otherwise have to recognize and include this economic income in her gross income.¹⁹⁸

Congress enacted a number of ISO-specific provisions to minimize the tax benefits of the ISO exclusion. Most importantly, the bargain purchase income realized by an employee in her ISO exercise is an AMT adjustment.¹⁹⁹ If the bargain purchase income plus the taxpayer's other AMT adjustments exceeds the AMT exemption amount,²⁰⁰ and if the taxpayer's "tentative minimum tax"²⁰¹ exceeds her regular income tax (with a top marginal tax rate of 38.6% in 2002),²⁰² she will owe AMT.²⁰³ Addi-

and thereafter, the phase-out of personal and dependency exemptions is scheduled to return. *Id.*

¹⁹⁵ See I.R.C. § 56(b)(1)(E).

¹⁹⁶ See I.R.C. §§ 56, 421.

¹⁹⁷ *Id.* § 421(a)(1).

¹⁹⁸ *Id.* § 83(e)(1).

¹⁹⁹ See *id.* § 56(b)(3).

²⁰⁰ After inflation adjustments, this amount would be approximately \$60,000–\$70,000 for married taxpayers filing jointly or surviving spouses. See Shaviro, *supra* note 30, at 1463.

²⁰¹ A taxpayer computes her tentative minimum tax by determining her AMTI in excess of any allowable exemption amount. I.R.C. § 55(b)(1)(A)(ii). This "taxable excess" is subject to tax at 26% for the first \$175,000, plus 28% on any excess above \$175,000. *Id.* § 55(b)(1)(A)(i). If indexed for inflation, the tax would be 26% on the first \$208,000, plus 28% on any excess above \$208,000. See Shaviro, *supra* note 30, at 1463.

²⁰² Rev. Proc. 2001-59, § 3, 2001-52 I.R.B. 623 (setting forth the 2002 tax rate tables for individual taxpayers under I.R.C. § 1(a)–(d) with ordinary income tax rates ranging

tionally, Congress has specifically limited the amount of ISO grants exercisable for the first time by any employee in any tax year to \$100,000 of stock, valued as of the date of the grant, in order to limit the amount of annual ISO tax benefits.²⁰⁴ Congress has further limited the potential ISO tax benefits by requiring employers to grant ISOs at an exercise price no less than the fair market value of the stock price.²⁰⁵ Therefore, on the date an employee receives an ISO from her employer, the bargain purchase income is zero.²⁰⁶ Furthermore, employers may not grant ISOs to individuals with 10% or more of the corporate voting power.²⁰⁷ Accordingly, Congress has limited ISO benefits to less than 10% owners and, effectively, limited the aggregate number of ISO grants to any one employee.²⁰⁸ These provisions ensure that excessive ISO grants will not qualify for favorable ISO tax treatment. Moreover, even if ISO grants meet the annual and aggregate ownership limitations, if an employee's bargain purchase income recognized in any one year is significant, she may have to pay AMT.²⁰⁹

There are several ways for ISO exercisers to minimize or even avoid AMT. An ISO exerciser will be subject to AMT only if her bargain purchase income plus her other AMT adjustments exceeds her exemption amount, and if her "tentative minimum tax" exceeds her regular income tax.²¹⁰ When an employee receives an ISO grant, she has zero bargain purchase income (that is, her ISO exercise price is no less than the fair market value of the stock).²¹¹ If an employee exercises her ISOs soon after the date of grant, she will have little or no bargain purchase income and, therefore, will not owe AMT. Moreover, annual and aggregate ISO

from 10% to 38.6%).

²⁰³ AMT is the excess of a taxpayer's tentative minimum tax over her regular tax for the taxable year. I.R.C. § 55(a).

²⁰⁴ *Id.* § 422(d)(1).

²⁰⁵ *Id.* § 422(b)(4).

²⁰⁶ Bargain purchase income is the excess of the fair market value of stock over its exercise price. If exercise price is equal to fair market value, bargain purchase income is zero.

²⁰⁷ I.R.C. § 422(b)(6). In any such case, I.R.C. § 422(c)(5) changes the total disqualification to a requirement that ISOs granted to any 10% or greater owner (measured by corporate voting power) must have an exercise price at least equal to 110% of the fair market value of the stock on the date of grant and a maximum term of five years.

²⁰⁸ ISO grants are limited on an annual basis to \$100,000 of stock value and must be exercised within ten years of the grant. *Id.* § 422(d), (b)(3). Thus, an employee-owner receiving the maximum annual ISO grants could attain ownership of 10% or more of the corporate voting power and, thereafter, be limited in her ISO tax benefits. *See id.* § 422(b)(6), (c)(5).

²⁰⁹ *See id.* §§ 56(b)(3), 55.

²¹⁰ If Congress indexes the AMT exemption, phase-out levels, and the tentative minimum tax calculation for inflation, then the exemption amount will be approximately \$70,000, and the tentative minimum tax will be 26% on the first \$208,000 of taxable excess and 28% on any amount of excess over \$208,000. *See Shaviro, supra* note 30, at 1463.

²¹¹ I.R.C. § 422(b)(4).

grants to each employee are also limited.²¹² Thus, ISO stock value would have to increase significantly from the date of grant to the date of exercise to generate enough bargain purchase income to cause an ISO exerciser to owe AMT if she exercises her ISOs soon after the grant.²¹³

Effective planning also may eliminate AMT liability. Employees exercising their ISOs immediately after the date of grant will have zero bargain purchase income and, therefore, will not owe AMT or regular income tax on the exercise.²¹⁴ The employee will defer recognition of any subsequent appreciation on her ISO shares until she sells them.²¹⁵ Any gain recognized after the end of the statutory holding period will be subject to tax at favorable long-term capital gain tax rates.²¹⁶ Employees holding ISOs with a significant amount of built-in bargain purchase income can manage their ISO exercises over time to minimize or even eliminate their AMT. ISOs can usually be exercised over a period of time of up to ten years from the date of grant.²¹⁷ Therefore, a holder can plan to exercise her ISOs in a manner that minimizes her overall tax liability.

Congress enacted favorable tax treatment for ISOs but intentionally limited the amount and scope of these tax benefits. Employers and employees can structure their ISOs to receive the maximum amount of tax benefits provided under the Code. Elimination of the ISO adjustment under the AMT is inconsistent with congressional intent to limit these benefits and to tax economic income.

V. THE AMT ADJUSTMENT FOR THE BARGAIN PURCHASE INCOME OF AN ISO EXERCISE PUTS ISOs ON PAR WITH NQSOs, OTHER EMPLOYEE BARGAIN PURCHASES, AND INVESTMENTS

Employees who receive any amount of compensation, NQSO exercisers, and employees benefiting from any bargain purchase from their employers must recognize these benefits, subject to ordinary income tax rates (up to 38.6% in 2002).²¹⁸ Correspondingly, if an employee realizes a significant amount of bargain purchase income upon exercise of her

²¹² The fair market value of shares (as of the date of grant) with respect to which all ISOs held by an employee may first become exercisable in any calendar year may not exceed \$100,000. *See id.* § 422(d). Employers may not grant ISOs to individuals with 10% or more of the corporate voting power. *Id.* § 422(b)(6), (c)(5).

²¹³ Without considering any phase-out of the exemption amount, the bargain purchase income plus other AMT adjustments would have to exceed \$70,000 on \$100,000 of initial stock value. Therefore, in order to owe AMT, an employee exercising the maximum annual stock value grant of \$100,000 during the first possible tax year would have to receive stock with a fair market value in excess of \$170,000, with an exercise price of \$100,000 (a 70% return on her investment).

²¹⁴ *See* I.R.C. §§ 56(b)(3), 55, 83.

²¹⁵ *See id.* § 1001.

²¹⁶ *See id.* §§ 422(a)(1), 1222, 1(h).

²¹⁷ *Id.* § 422(b)(3).

²¹⁸ *See id.* §§ 1(i), 61, 83; Rev. Proc. 2001-52, 2001-59 I.R.B. 623.

ISOs, she will have to pay AMT at a current tax rate of up to 28%.²¹⁹ If qualifying ISO stock later declines in value, the employee cannot offset the decline against her previously recognized income, but instead must recognize her capital loss subject to any capital loss limitations.²²⁰ Similarly, if stock acquired by NQSOs or any other bargain-purchased asset declines in value, an employee cannot reduce previously recognized income, but must likewise recognize her capital loss subject to any capital loss limitations.²²¹ Thus, ISO exercisers with significant amounts of bargain purchase income must pay AMT and will receive tax treatment on par with other employee investors.²²²

Employees who use their compensation to make independent investments in the stock market must pay ordinary income and payroll taxes on that compensation. If the stock investments subsequently decline in value, the only way that those employees could realize a tax benefit would be by selling the stock and recognizing a capital loss, which then could be offset first against recognized capital gains and then against ordinary income up to \$3,000 per tax year.²²³

Likewise, employees exercising NQSOs pay ordinary income and payroll taxes on the bargain purchase income realized from their exercises. If the stock they acquire subsequently declines in value, they have no ability to offset previously recognized ordinary income subject to tax at ordinary income tax rates. Once again, these employees' only tax benefit from a sale of the depreciated stock is to recognize a capital loss.²²⁴

Similarly, employees who benefit from any bargain purchase of property from their employers (for example, any bargain purchase of a car, boat, furniture, or other property) will recognize ordinary income

²¹⁹ See I.R.C. §§ 55, 56(b)(3).

²²⁰ See *id.* § 1211(b).

²²¹ *Id.*

²²² See J. COMM. ON TAXATION, 106TH CONG., OVERVIEW OF FEDERAL INCOME TAX PROVISIONS RELATING TO EMPLOYEE STOCK OPTIONS 2 (Comm. Print 2000) (stating that ISO transactions under the AMT are treated the same as NQSO transactions). Similarly, if the gain on a sale of qualified small business stock is significant, an AMT adjustment effectively eliminates the tax preference for qualified small business stock gains and taxes such gains like any other long-term capital gain. See I.R.C. § 57(a)(7). Currently, a shareholder realizing a gain on the sale of qualified small business stock may exclude 50% of such gain from income. *Id.* § 1202(a). The 50% recognized gain is subject to tax at a 28% long-term capital gain tax rate. *Id.* § 1(h)(5)(A)(ii). Therefore, the effective tax rate on the gain recognized is 14%. Under the AMT, 21% (42% of the 50% excluded gain) must be added back to taxable income. See *id.* § 57(a)(7). As a result, 71% of the gain on qualified small business stock is included in AMTI and subject to tax at 28%; therefore, the effective tax rate for qualified small business stock gains is approximately 20% (71% of the gain x 28% tax rate), which is the maximum tax rate for long-term capital gains. *Id.* § 1(h)(1)(C). In this way, the AMT adjustment eliminates the preferential tax treatment for qualified small business stock and puts such gains on par with other long-term capital gains.

²²³ See I.R.C. § 1211(b).

²²⁴ *Id.*

subject to income and payroll taxes.²²⁵ They also risk depreciation of their purchased assets to levels below the market value on the date of purchase. If the purchased assets decline in value, the employee's only potential for recognizing any tax benefit on realized economic losses and sale of such assets would be through limited capital loss tax benefits.²²⁶

Thus, the AMT adjustment for ISO exercisers merely puts such employees in the same tax position as employee investors, NQSO exercisers, and other employee bargain purchasers described above. Even if ISO stock declines in value after the date of exercise, an employee's tax position is no worse than any other employee investor subject to capital loss limitations. Eliminating the AMT adjustment for ISO exercisers would anomalously allow them to pay lower long-term capital gain tax rates on an unlimited amount of bargain purchase income and to defer taxes until they sell their ISO stock.

VI. CONCLUSION

People want just taxes, more than they want lower taxes. They want to know that every man is paying his proportionate share according to his wealth.

—Will Rogers²²⁷

The AMT system is broken and must be fixed. Given the current projected budget deficits, Congress might not be in a position to incur the enormous costs of repealing the individual AMT. Nonetheless, Congress will have to make significant amendments to the AMT system to get it back on track to achieve its intended goals. As more and more taxpayers become liable for AMT, resistance will become an increasingly serious problem for the tax system.

Congress should amend the individual AMT to focus its impact on high economic income taxpayers and to simplify its rules and influences on business transactions. ReformAMT is lobbying for elimination of the AMT adjustment for ISO exercises. The ISO AMT adjustment, however, is the type of adjustment Congress intended: a tax on significant economic income that would otherwise escape current taxation. However, other reforms would increase AMT transparency and decrease the number of middle- and low-income taxpayers subject to AMT while meeting

²²⁵ This does not include allowable employee discounts. *See id.* § 132(c) (allowing qualified discounts to be excluded from an employee's gross income).

²²⁶ *See id.* §§ 1211(b) (limiting recognized capital losses to recognized capital gains plus \$3,000), 165(c) (disallowing any loss from the sale of a personal use asset, such as a car or personal residence).

²²⁷ Jeffrey L. Yablon (compiler and arranger), *As Certain as Death—Quotations About Taxes (Expanded 1997 Edition)*, 77 TAX NOTES 1485, 1497 (1997).

the original intent of the AMT system. If Congress indexes for inflation the AMT exemptions, phase-out thresholds, and tax rate brackets, many middle- and low-income taxpayers will no longer be subject to the AMT. Only taxpayers who have realized a significant amount of economic income not subject to regular income taxes should pay AMT. By also eliminating adjustments for state and local tax deductions and personal and dependency exemption deductions, Congress can ensure that taxpayers are not arbitrarily subjected to AMT liability merely because they happen to live in a high-tax state or have a large family.

Simplification of the AMT will increase the system's legitimacy by improving taxpayer understanding of the application of the AMT and its tax calculations. Once taxpayers understand these rules, they can manage their transactions to minimize their overall tax costs, including reducing any AMT.²²⁸ Most vitally, fewer taxpayers should find themselves in the financially devastating position of recent ISO exercisers. In the future, we likely will see AMT reform that will save many ISO exercisers from AMT liability, but it will probably be packaged in AMT amendments that do not modify the AMT adjustment for the bargain purchase income from an ISO exercise.²²⁹

²²⁸ Taxpayers legitimately may structure their ISO transactions so as to minimize their tax:

Over and over again courts have said that there is nothing sinister in so arranging one's affairs as to keep taxes as low as possible. Everybody does so, rich or poor; and all do right, for nobody owes any public duty to pay more than the law demands: taxes are enforced extractions, not voluntary contributions. To demand more in the name of morals is mere cant.

Comm'r v. Newman, 159 F.2d 848, 850-51 (2d Cir.) (L. Hand, J., dissenting), *cert. denied*, 331 U.S. 859 (1947).

²²⁹ See Amy Hamilton, *Congress Hands Thorny AMT Issue to Taxpayer Advocate*, 93 TAX NOTES 755, 755 (2001) (noting that congressional staff for the taxwriting committees has consistently told National Taxpayer Advocate that there will be no legislative fix for ISO exercisers).

