

Pittsburgh Business Times - May 14, 2007

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Friday, May 11, 2007

# Incentivized stock options, little-known tax code bad mix

Pittsburgh Business Times - by [Joe Nicola](#)

When Congress enacted the federal income tax code, one of its purposes was to establish a fair and equitable income tax system.

Fundamentally, the tax law attempts to exact tax responsibility generally in proportion to one's ability to meet his or her fiscal obligations, and most taxpayers understand this basic premise. Beyond this, however, the tax law is not conducive to easy interpretation.

Most practitioners who work with the code on a daily basis readily admit that the application of the tax law to the diversity of fact patterns encountered in practice can be often discouraging. Recently, this has been punctuated by the impact of the alternative minimum tax, or AMT, system.

## **AMT an unknown**

AMT parallels the regular tax system, but is relatively unknown. It was originally designed to levy a tax on certain benefits thought generally to be available only to taxpayers in the higher tax brackets.

But because of the mathematical process by which the AMT is computed, and the lack of congressional attention to the impact of inflation on this tax system, large numbers of the middle class have become subject to the tax.

Now the AMT has become somewhat unstoppable, since its size and strength generate significant revenue for the federal government, and Congress is aware of this. As such, taxpayers must deal with the consequences, and working with the AMT provisions within the tax code can be a mind-bending experience.

## **STOCK OPTIONS**

One of the most significant aspects of the AMT is its impact on employee incentive stock options.

As most people are aware, incentive stock options have been employed with great frequency in the high-technology industry (often by startup enterprises) as a means to attract employees. Generally, employees are not taxed upon the grant of options, nor are they taxed upon exercise of the options. When the stock is ultimately sold, its disposition generally gives rise to long-term capital gain.

The trap for the unwary lies in the application of the AMT system. Unlike the regular tax system, the AMT system generally requires employees to recognize income upon exercise, in an amount that is equal to the difference between the fair market value of the underlying stock and the strike price (i.e., the cost of the underlying stock to the employee).

Great media attention has been directed to employees who have exercised options to purchase what is now worthless stock. The AMT consequences are disastrous.

Consider the following example: Suppose that, in 2001, an employee was granted an option to purchase 1,000 shares of employer stock at \$1 per share at a time when the value of the stock was \$15 per share.

Suppose further that, in 2004, the employee exercised the options, and bought the stock for \$1,000 (when it was worth \$91 per share, or \$91,000). For regular tax purposes, assuming that all other requirements of the tax code were satisfied, the employee recognized no taxable income in 2004.

For alternative minimum tax purposes, however, the employee was required to report \$90,000 of income (or the difference between the stock's \$91,000 fair market value and its \$1,000 cost). Now, suppose that the stock value declines in late-2007 to \$1 per share, and the employee sells the stock for \$1,000.

For regular tax purposes, the employee has no gain or loss, since the selling price of the stock (\$1,000) equals its tax basis (the employee's cost, which is also \$1,000). For AMT purposes, however, the employee has a tax basis of \$91,000 (the cost of \$1,000, plus the reported alternative minimum taxable income of \$90,000).

The sale thus produces a 2007 capital loss under the AMT system of \$90,000, which is nondeductible. It cannot be carried back by way of an amended return to reduce the alternative minimum tax paid upon the exercise of the options in 2004.

Rather, it can only be used in the future to annually offset \$3,000 of ordinary AMT income (over roughly 30 years).

In some very recent litigation, taxpayers have challenged the lack of equity of this result, but the courts invariably indicated that the "fix" is not within the power of the Internal Revenue Service or the judicial system, but rather rests exclusively with Congress.

Planning is essential to reduce the impact of the AMT on options, since the AMT system seems to be here to stay.

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