



Tax Court offers no help for AMT on ISO exercise

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By Roger Russell

Washington - A ruling by the Tax Court has underscored the way the alternative minimum tax penalizes holders of incentive stock options when the stock loses value after the option is exercised.

Ronald Speltz thought that his employer was doing him a favor by issuing him ISOs to augment his salary, which was about \$70,000 a year. Instead, the ISOs triggered a tax nightmare when he exercised them before the tech bubble burst, leaving him with nearly worthless stock but with an unexpected tax bill of close to \$225,000.

Although Speltz and his wife borrowed \$134,000 to help pay state and federal taxes, and offered the cash value of his life insurance policy as a compromise for the remainder, the Internal Revenue Service rejected his offer.

The Tax Court agreed.

Even though the offer-in-compromise provisions include a compromise to promote effective tax administration - explained by the regs to cover situations "where collection in full could be achieved but would cause economic hardship" - the court found that the Speltzes had sufficient income to meet "basic living expenses" and therefore didn't qualify. The court said that it sympathized with the situation, but it is up to Congress, not the courts or the IRS, to come up with a solution.

The ISO AMT crisis is causing extreme financial hardship for many employees of small and large companies, according to the Coalition for Tax Fairness, an organization working to resolve the anomaly. The AMT tax often results in taxes exceeding 400 percent of these employees' annual salaries, with the double whammy that they never see any actual income from the worthless stock.

"We are crushed and disheartened that the Tax Court did not grant relief, as we have always believed that the laws are intended to be fair for all Americans," said Ron Speltz. "Being forced to pay more than 11 times what the normal taxpayer would pay in taxes is destroying us financially and has caused immense stress and hardship for more than four years. We plead with Congress to please act quickly to put an end to this nightmare, before we lose everything we have and are destroyed financially for years to come."

Unfortunately for the Speltzes, the Tax Court opinion leaves no legal option, according to Tim Carlson, the attorney for the Speltzes and president of the Coalition for Tax Fairness.

"The only hope for the Speltzes, and others like them, is for Congress to take action to correct this serious injustice," Carlson said, adding, "I am encouraged at the attention that Congress is paying to this issue, and the bi-partisan support that is building in both the House and Senate for legislation to correct this unintentional harm to hardworking, honest taxpayers."

"It is unfair, considering all of the factors," agreed Laurie Asch, senior tax analyst at New York-based RIA. "But the courts maintain that even though the law is unfair, it's unfair to everyone, and the taxpayer has not shown that it's unfair to him specifically. Therefore they say it's up to Congress to fix, not the courts."

"The fact that it's a hot topic probably worked against the taxpayers," she noted. "It shows that Congress is aware of the discrepancy but hasn't chosen to address it."

That will change, hopes Carlson, who has been working with several groups and congressional tax writers to draft legislation that would address the problem.

"They were looking at what Congress wanted them to do and they got blindsided," he said. "For most people, the worst that can happen is they lose everything, but for someone hit with the ISO AMT, they lose everything and find themselves in a negative hole. The Speltzes lost \$30,000 on the stock, plus they end up owing a quarter of a million dollars."

Carlson believes that the equitable relief provision, added in 1998 legislation, should cover cases like the Speltzes. "I think they're entitled to relief under the plain language of the statute and the regs," he said. "The IRS is working a double standard - here they claim to follow the strict letter of the law, yet they undermine the congressional intent behind the equitable relief posited by Code Section 7122. On the other hand, they're quite willing to go beyond the strict letter of the law and follow 'economic substance' when the topic is tax shelters."

Dayton, N.J.-based CPA and attorney E. Martin Davidoff, tax liaison chair for the American Association of Attorney-CPAs, likewise sees a legislative fix as the solution.

"This is a case for Congress to fix, and Congress really should just fix it," he said. "The case highlights the problem with the market going down precipitously. The stock loss suffered by taxpayers in these circumstances leaves them without any income, and with no means to pay tax on the phantom income."

"It's a terrible inequity on people that it hits, and Congress could fix it by simply raising the rate a fraction of a point and eliminating the ISO as a tax preference."

In a recent report to Congress, National Taxpayer Advocate Nina Olson made it clear that she believes the effective tax provisions in the code would cover unfair application of the AMT.

"The IRS summarily rejects ETA offers in cases where one of the inequities faced by the taxpayer is an 'unfair' operation of the AMT," she stated. "The IRS reasons that a compromise of AMT liabilities would circumvent the will of Congress. However, this position overlooks the possibility that the 'unfair' operation of the tax rules may be one of many factors that may justify the acceptance of an ETA offer based upon the unique circumstances of a particular taxpayer."

For his part, Speltz was only vaguely aware of the consequences when he exercised his options in 2000.

"I knew there would be some tax, but I had no idea it would be that much, nor any idea it would be that unjust," he said. "I thought that 'income tax' means you're taxed on income, and we had no income, so I didn't think it would amount to much."