



Testing the Limits—The \$3,000 Capital Loss Cap and the AMT
May 6, 2006



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AMT and the \$3,000 Capital Loss Limit

The Tax Court recently took a look at an issue that the court had not directly considered before relating to the interaction of the alternative minimum tax basis adjustment on incentive stock option shares that a taxpayer sells and the limitation on the deduction of net capital losses that applies generally under the IRC for regular tax purposes. Under the regular income tax, net capital losses for taxpayers other than corporations are limited by §1211(b) which provides:

1211(b) OTHER TAXPAYERS. --In the case of a taxpayer other than a corporation, losses from sales or exchanges of capital assets shall be allowed only to the extent of the gains from such sales or exchanges, plus (if such losses exceed such gains) the lower of --

1211(b)(1) \$3,000 (\$1,500 in the case of a married individual filing a separate return), or

1211(b)(2) the excess of such losses over such gains.

Now we consider the alternative minimum tax and incentive stock options. ISOs, for regular tax purposes, evade the general rule for compensatory stock options that a taxpayer must recognize as ordinary income the difference between the exercise price and the value on the date of exercise. However, for the alternative minimum tax, Congress takes back this break by removing that exclusion with the following provision in §56(b)(3):

56(b)(3) TREATMENT OF INCENTIVE STOCK OPTIONS. --

Section 421 shall not apply to the transfer of stock acquired pursuant to the exercise of an incentive stock option (as defined in section 422). Section 422(c)(2) shall apply in any case where the disposition and the inclusion for purposes of this part are within the same taxable year and such section shall not apply in any other case. The adjusted basis of any stock so acquired shall be determined on the basis of the treatment prescribed by this paragraph.

The final line above provides the key issue that the court would have to deal with—what do we do with that extra basis on the sale of stock. The key issue is that since the taxpayer's basis will be higher for the alternative minimum tax than for the regular tax, do we recalculate the limitation under §1211 for AMT purposes (so that we cap the net capital loss deduction at \$3,000 for AMT purposes each year) or is the basis adjustment independent of those provisions.

When the Stock Price Crashes

For regular tax purposes, to preserve the benefit of an ISO and get the capital gains rate on the difference between the exercise price and the fair value on the date of exercise, taxpayers must hold the shares for longer of two holding periods—one year from the date of exercise or two years from the date of grant. What that means is that taxpayers will, at a minimum, have to hold the shares for one year to lock in the lower gain rate.

In *Merlo v. Commissioner*, 126 TC No. 10, we see the potential downside of trying to wait out the gain period. Nearing the end of 2000, Mr. Merlo did the following:

On December 21, 2000, petitioner exercised an option to purchase 46,125 shares of Exodus common stock at 20 cents per share, for a total exercise price of \$9,225. The price of the optioned stock on the NASDAQ on December 21, 2000, was \$23.3125 per share, for a total fair market value of \$1,075,289 on the date of exercise.

The options in question were ISO options.

While Mr. Merlo actually attempted to argue various reasons why that spread should not have been included in AMT income after Congress did not pass a revision he had gone ahead and used in preparing his 2000 return that would have capped the amount included to the lesser of the spread at exercise or the spread on the due date of his return, in the end he had to include the entire spread in his 2000 AMT income. So Mr. Merlo had shares with a regular tax basis of \$9,225 and a basis for alternative minimum tax purposes of \$1,075,289.

Unfortunately, the value of Exodus stock didn't hold up well over time—even over a relatively short period of time. By April 15, 2001 (which Mr. Merlo had to file his 2000 income tax return) that spread had dropped to less than half the amount that existed on December 21.

But things got worse long before the one year holding period expired. The opinion notes that:

Exodus filed for bankruptcy on September 26, 2001. In a press release dated November 21, 2001, Exodus announced that the company's common stock had no value. Petitioner's shares of Exodus stock were worthless as a result of Exodus's bankruptcy.

So Mr. Merlo now had a capital loss based on worthless shares. For regular tax purposes that loss was \$9,225. However, for alternative minimum tax purposes, that loss would be \$1,075,289. If the \$3,000 a year limit applied to this loss, Mr. Merlo could be looking at a lifetime AMT capital loss carryover.

The Court's Analysis

Mr. Merlo argued that the \$3,000 limitation should not apply to the basis adjustment triggered by the initial application of §56(b)(3) and that, in addition, the loss so recognized should add to the alternative minimum tax net operating loss deduction under §56(a)(4), as defined at §56(d). His view was that the limitations applicable to the calculation of both the \$3,000 limitation and the net operating loss exclusion of capital losses from calculation of a net operating loss were limited to being applied to the regular tax items, and that the adjustments related to §56(b)(3) should not have to pass through those limitations.

The court noted:

The Internal Revenue Code does not explicitly address the treatment of capital losses for AMT purposes. See secs. 55-59, and accompanying regulations...

This Court has never addressed whether the capital loss limitations of sections 1211 and 1212 apply for purposes of calculating a taxpayer's AMTI.

The court looks to Regulation 1.55-1(a) to attempt to resolve this matter. That regulation provides:

(a) *General rule for computing alternative minimum taxable income.* --Except as otherwise provided by statute, regulations, or other published guidance issued by the Commissioner, all Internal Revenue Code provisions that apply in determining the regular taxable income of a taxpayer also apply in determining the alternative minimum taxable income of the taxpayer.

The Tax Court concludes based on this provision that the limitation of §1211(b) does apply for purposes of computing the AMTI. Thus, Mr. Merlo is limited to a net loss of \$3,000 per year and, as a practical matter, in the absence of a large capital gain somewhere down the line may have a “lifetime” supply of capital loss carryover for AMT purposes.

The Court goes on to note that even to the extent he has an allowable net AMT capital loss, that would not directly increase his ATNOL. The Court notes:

Petitioner's net regular capital loss is excluded from computing his NOL deduction. See sec. 172(c), (d)(2)(A); sec. 1.172-3(a)(2), Income Tax Regs. For AMT purposes, petitioner's ATNOL is the same as his NOL, taking into consideration all the adjustments to his taxable income under sections 56, 57, and 58. See sec. 56(a)(4), (d)(1). No adjustments under those sections modify the exclusion of net capital losses from the NOL computation under section 172(d)(2)(A). Therefore, petitioner's net AMT capital loss is excluded for purposes of calculating his ATNOL deduction. As a result, petitioner's AMT capital loss realized in 2001 does not create an ATNOL that can be carried back to 2000 under sections 56 and 172(b).

But It Just Isn't Fair

Finally, the taxpayer argues that this result both defeats what he feels was the Congressional intent for the AMT and is a clearly unfair result that the Court needs to address.

The Court rejected his Congressional intent arguments, indicating that he only broadly addressed a committee report and had nothing directly on point to show that Congress really meant for the law to work as he suggested. As well, I would suggest from prior rulings in the AMT area, it's not likely the Court would have changed its ruling even if he had found a sentence in the Committee Reports unless he also could have shown that the law itself was ambiguous on the point in question.

On the issue of fairness, the Tax Court again resorted to the “I feel your pain” response but noted the Court is not the venue to get relief in this area:

Petitioner also advances several "policy and legal considerations". Essentially, petitioner is arguing that, under principles of equity, he should be allowed to carry back his AMT capital loss to reduce his AMTI. Petitioner feels that applying the

capital loss limitations of sections 1211 and 1212 to the calculation of his AMTI results in harsh and unfair tax consequences.

This Court has previously stated:

The unfortunate consequences of the AMT in various circumstances have been litigated since shortly after the adoption of the AMT. In many different contexts, literal application of the AMT has led to a perceived hardship, but challenges based on equity have been uniformly rejected. * * *

* * * "it is not a feasible judicial undertaking to achieve global equity in taxation * * *. And if it were a feasible judicial undertaking, it still would not be a proper one, equity in taxation being a political rather than a jural concept." * * * the solution must be with Congress.

Speltz v. Commissioner, 124 T.C. at 176 (quoting *Kenseth v. Commissioner*, 259 F.3d 881, 885 (7th Cir. 2001), affg. 114 T.C. 399 (2000)); see also *Alexander v. Commissioner*, 72 F.3d 938 (1st Cir. 1995), affg. T.C. Memo. 1995-51; *Okin v. Commissioner*, 808 F.2d 1338 (9th Cir. 1987), affg. T.C. Memo. 1985-199; *Warfield v. Commissioner*, 84 T.C. 179 (1985); *Huntsberry v. Commissioner*, 83 T.C. 742, 747-753 (1984). Petitioner's equity and public policy arguments offer no relief from the tax consequences of the AMT Code sections, as outlined above.

Lessons

Mr. Menlo's case provides a couple of lessons. First, while not the final word, it does seem to make it clear that a taxpayer who wants to argue that the capital loss limitations do not apply to ISO exercise is going to have to get to a venue other than the Tax Court to carry this argument. We now have a reported Tax Court decision on this matter which represents, to date, the only ruling I've found on the issue. Given that fact, the IRS is not likely to give up on this issue on exam even if you feel you still have a good argument.

Second, as a practical matter, Mr. Menlo was put in a tough position when he exercised so close to the year end. There is a relief provision in the law that can solve ISO problems when the stock price drops, and it's referred to in §56(b)(3) above. §422(c)(2) is a relief provision to stop taxpayers from being "whipsawed" by having to include the spread as both ordinary income and then a capital loss if they do a disqualifying disposition—but only if that disqualifying disposition takes place in *the same taxable year*. That provision provides:

422(c)(2) CERTAIN DISQUALIFYING DISPOSITIONS WHERE AMOUNT REALIZED IS LESS THAN VALUE AT EXERCISE. --If --

422(c)(2)(A) an individual who has acquired a share of stock by the exercise of an incentive stock option makes a disposition of such share within either of the periods described in subsection (a)(1), and

422(c)(2)(B) such disposition is a sale or exchange with respect to which a loss (if sustained) would be recognized to such individual, then the amount which is includible in the gross income of such individual, and the amount which is deductible from the income of his employer corporation, as compensation attributable to the exercise of such option shall not exceed the excess (if any) of the amount realized on such sale or exchange over the adjusted basis of such share.

When Mr. Menlo exercised at December 21, he had only 10 days in which he could make use of this provision, which is effective for both the regular tax and the AMT.

However, note that there is a trap for the unwary here--§422(c)(2) requires that a loss would be *recognized* except for this provision. While not totally clear, it certainly seems reasonable that a taxpayer would have to steer clear of the wash sale provisions of §1091. If §1091 would block recognition of the loss, then the requirement of §422(c)(2) have not been met—in which case we'd be back to recognizing the full spread as ordinary income and a short term capital loss that we can't recognize, but which instead gets added back to basis.

What I tell clients is that they need to be aware that exercising ISOs with a view towards holding them for a year to get the capital gain treatment has higher risks the later in the year they exercise, and that there is going to be a period of exposure when a crash could be very expensive. As well, I remind them that if they do exercise and the price drops dramatically before year end, we need to run the numbers to see if disqualification along with avoiding the wash sale provisions makes sense for them.