



Let's Try This Again-Another AMT Capital Loss Theory Loses
Podcast of October 14, 2006



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AMT Capital Loss Adjustments

A few weeks ago we discussed the Tax Court's observations on how the alternative minimum tax interacts with the capital loss limitations, an issue of great interest to many of those who exercised incentive stock options at the peak of the dot-com boom, only to see the value of their shares drop dramatically before they were able to sell the stock. In that case, *Merlo v. Commissioner*, 25 T.C. 205, the Tax Court ruled that capital losses for AMT purposes were generally limited by the same \$3,000 limitation that applies for the regular tax computation.

This week the Tax Court cleans up a bit of a loose end on the topic in another case involving similar facts to those in *Merlo*—the case of *Palahnuk v. Commissioner*, 127 T.C. No. 9. In addition to the theories put forward in *Merlo* and rejected by the Tax Court, the taxpayers in this case attempted to argue they should at least be able to take a

subtraction for the gain they recognized for regular tax purposes, even though they offset that gain with capital losses.

Facts of Palahnuk

The story here is one that should be familiar to those that had taxpayer with high tech companies a few years ago. Jonathan Palahnuk exercised ISO issued by his employer in 2000 for \$99,949 at a time when the stock was worth \$2,185,958. Since these were ISO shares, he recognized no income for regular tax purposes, but had to recognize over \$2,000,000 of the spread in computing the alternative minimum tax. In this case, a minimum tax of over \$580,000 was triggered.

The holder of the ISO can get capital gain treatment for the difference between the exercise price and his eventual sales price of the shares if he meets the holding period requirements. That means he can't sell the shares before the later of two years from the date of grant of the option or one year from the date of exercise. In most cases the options are exercised more than a year after grant, so generally holders are looking at a sale one year from the date of exercise to get capital gain treatment for regular tax purposes.

While the alternative minimum tax is generally paid in the year of exercise (especially when you have the large spread found in a case like this), a minimum tax credit generally arises and the holder gets the higher basis for alternative minimum tax gain computation purposes. Thus, when the shares are sold the holder computes a lower gain for alternative minimum tax purposes, which expands the spread between tax computed under the regular tax and alternative minimum tax systems. Jonathan had a minimum tax credit carryforward from 2000 of over \$540,000 (the remaining AMT was allocable to exclusion items).

All works relatively well if the shares continue to appreciate, but §1211 serves to greatly limit the ability to deduct capital losses if there are not offsetting capital gains. In *Merlo* the Tax Court decided that the same \$3,000 limitation applies in computing the alternative minimum tax as applies in computing the regular tax. If that comes into play, the recovery of the additional AMT basis may be greatly delayed—coming against income at a level of \$3,000 a year.

Back to our taxpayer's story: By the time the taxpayer sold his shares the following year, the shares were worth \$248,410—still substantially more than the exercise price, but well below the amount he had paid AMT tax on in the prior year. Jonathan went ahead and sold off loser stocks to offset his regular tax capital gains and generate a \$3,000 regular tax loss.

Original Tax Return Position

Jonathan originally took the position on his return that he was allowed to take a subtraction for alternative minimum tax purposes of the entire difference in basis in the

year he sold the stock. That reduced his AMTI to below zero, thus wiping out his tax liability for 2001 entirely, since the entire regular tax liability could be offset by minimum tax credit. Similarly, the taxpayers argued that this generates an alternative minimum tax net operating loss as well.

Unfortunately, in the *Merlo* case the Tax Court rejected both theories, and Judge Laro applies the same ruling here to disallow the position. In fact, as noted in footnote, the taxpayers acknowledged before trial that the issue had been decided adversely to their position while the case was in process. So the taxpayers resort to an alternative position to attempt to salvage some benefit—a position that seems to have given rise to this case being a reported Tax Court decision.

In the Alternative

Maybe they could salvage this matter, the taxpayers though, if we try a slightly different argument. After all, we know that the Tax Court (and the specific judge hearing this case) had rejected the theory that the alternative minimum tax is a parallel system in *Allen v. Commissioner* (118 T.C. No. 1) back in 2002. So perhaps they might be able to persuade the court that they should at least get to subtract the gain being included for regular tax purposes, even though it was being offset by other capital losses.

Judge Laro summarizes the taxpayers' position as follows:

Alternatively, petitioners argue, they may compute their 2001 AMTI by subtracting from their 2001 taxable income the \$151,461 difference between the \$148,461 regular tax capital gain for 2001 and the \$3,000 allowable AMT capital loss for 2001. According to petitioners, this difference is a net operating loss negative adjustment that reduces their 2001 taxable income.

It appears they hoped that since the systems aren't parallel, they could simply remove the "excess gain" that had flowed through the regular tax computation.

Unfortunately, the Court didn't buy the argument. In fact, Judge Laro specifically refers to the *Allen* decision in explaining why he rejects their theory.

In *Allen v. Commissioner*, supra at 10, we explained that an individual calculates AMTI by first computing regular taxable income and then making the necessary alterations to reflect the items described in part VI. Thus, petitioners must calculate their 2001 AMTI by adjusting their 2001 taxable income to reflect the mandate of section 56(b)(3) that their AMTI be computed using their AMT adjusted basis in the stock acquired through the exercise of petitioner's ISO rather than their regular tax adjusted basis in that stock. In other words, given that petitioners computed their 2001 taxable income by factoring in a \$3,000 capital loss, petitioners' adjustment under section 56(b)(3) must reflect the substitution of that \$3,000 capital loss with the \$3,000 allowable portion of their 2001 AMT capital loss (discussed below).

Petitioners calculate their 2001 AMTI by reducing their taxable income by the \$148,461 regular tax capital gain attributable to petitioner's ISO (rather than the \$3,000 capital loss factored into the computation of their 2001 taxable income). We do not do similarly. In addition to the sales underlying the \$148,461 capital gain, petitioners had other sales of capital assets during 2001. Although those other sales were unrelated to petitioner's ISO, they are nevertheless sales that entered into the calculation of petitioners' 2001 regular tax capital loss and, hence, must necessarily enter into the calculation of petitioners' adjustment under section 56(b)(3). Considering all of the sales together, petitioner realized a regular tax capital loss of \$5,164 (the sum of the non-ISO losses of \$153,625 and the regular tax ISO gains of \$148,461) and an AMT capital loss of \$2,091,170 (the sum of the non-ISO losses of \$153,625 and the AMT ISO losses of \$1,937,547). The recognition of both the regular tax capital loss and the AMT capital loss is limited to \$3,000, see sec. 1211(b); see also *Merlo v. Commissioner*, supra (section 1211(b) limits an individual's annual deduction of an AMT capital loss to \$3,000), which, in turn, means that petitioners' adjustment under section 56(b)(3), representative of the difference between the recognized losses for regular tax and AMT purposes, is zero as determined by respondent.

In essence, you have to still recognize the other losses when computing the limitation the AMT loss.

Issues

Unfortunately, back in the dot com boom days it was difficult to discuss these issues with clients, since they tended to believe their stock would only go up so this wasn't an issue. But note that in many of these cases, the problem could have been substantially reduced if, towards the end of the calendar year of exercise, the stock had been disposed of and the relief provisions of §422(c) triggered to disqualify the option and limit the inclusion in income to only the spread on the date sold.

That does raise a planning point—given the significantly better results if the losers are dumped before December 31 of the year of exercise, clients thinking about exercising ISOs may, if they can, plan on exercising early in the year in order to give the shortest exposure to a drop in value.