
Exec battles IRS over options profits

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Like thousands of other technology executives, Nield Montgomery took the majority of his pay in stock options. That saved his start- up company cash and gave him the chance to make a killing if his company succeeded.

In the industry's heyday, it also made Montgomery a millionaire - - on paper. But like many others, he never got a chance to reap those riches in real life. His company's shares plunged in value before he could sell them. The only lasting legacy: a crushing federal income tax bill from the paper profit.

"I never got anything other than a tax obligation for running a company for three years, selling it and taking stock instead of cash," said Montgomery, who lives in Las Vegas. "It was the biggest tax bill I have ever seen."

The bill was $2.8 million, to be specific. When Montgomery ran $200,000 short of the cash needed to pay it, the IRS got ready to seize his home -- and Montgomery hired lawyers.

In a U.S. Tax Court decision last month, Montgomery won the right to stop the IRS collection effort while he disputes the underlying tax liability. His attorneys believe their challenge can dramatically flip Montgomery's fortune.

Montgomery now contends that he actually is owed a refund of $500,000, arguing that the stock options for which he paid so dearly were improperly valued on his tax return because they were not readily salable.

The IRS has 90 days to decide whether to appeal the ruling.

"Stock options are supposed to be such a wonderful thing, but the tax on them has ruined many lives," said one of Montgomery's lawyers, Duncan Turner, who works for Badgley Mullins Law Group in Seattle. "It's left people destitute."

Montgomery's story begins in the mid-1990s, when he started a small telephone company in Las Vegas. In lieu of cash, Montgomery paid himself primarily through a series of stock option grants, which would give him the right to buy shares at a set price at some point in the future. After the company went public in 1998, he was able to buy 1.6 million shares of stock for a fraction of the market price.

But he couldn't turn around and sell those shares immediately -- and convert that paper profit into cash -- because of restrictions in the employment contract he agreed to when he took the company public.

When an executive holds on to stock purchased at a discount because of stock options, he often falls into the murky world of the alternative minimum tax. The AMT was instituted to ensure that wealthy filers wouldn't be able to shelter all of their income from taxes. All taxpayers are supposed to calculate their liability twice
-- once via the normal system on the 1040 tax form and once via the AMT
-- and pay the higher of the two.

But most taxpayers ignore the AMT because it comes into play only in fairly unusual situations. One of the most costly of those situations is Montgomery's, when workers reap big paper profits by exercising stock options.

An option, for example, might give the right to buy 1,000 shares at $10 a share. If the company's share price rises to $100, that option is worth $90,000. But whether the employee will enjoy a real profit to put in the bank depends on the market price when he or she sells those shares.

Ordinarily, paper profits are not taxable. Tax is due only when stock is sold and a real profit is realized. But the AMT demands that the paper profits be added into income.

Because of that paper profit, Montgomery figured his 2000 tax obligation at $2.8 million. But because Montgomery's profit was on paper, not in the bank, he didn't have enough cash to pay the bill. Meanwhile, the value of the stock was plunging.

He eventually sold all the stock to pay the tax. It wasn't enough. The IRS initiated collection proceedings and placed a lien on his home. Then Montgomery heard about Bellevue, Wash.-based certified public accountant Brian Isaacson, who believes the IRS position on the taxation of stock options was open to challenge.

Isaacson says many taxpayers pay too much tax on their stock gains because they fail to account for the limitations on their right to sell the shares. When there are no restrictions limiting when an executive can sell stock, the right way to determine the profit is clear: The executive subtracts the purchase price from the market value.

However, if the executive is barred from selling the shares for an extended period of time, as Montgomery was, the value of the shares needs to be discounted to reflect the cost of the restriction, Isaacson says. The right discount rate, he says, will depend on the duration of the restrictions and the volatility of the stock. Although few have used discounts to value exercised stock options, tax officials note that the practice is widely accepted to value non-liquid investments in estate planning.

Although Montgomery won that recent round in U.S. Tax Court, whether he and his lawyers ultimately prove successful in pressing his refund claim remains to be seen.

"We're all holding our breath," said Rebecca Metz, founder of the Oakland-based advocacy group ReformAMT.

Los Angeles Times staff writer Kathy M. Kristof, author of "Taming the Tuition Tiger" and "Investing 101," welcomes your comments and suggestions but regrets that she cannot respond individually to letters or phone calls. Write to Personal Finance, Business Section, Los Angeles Times, 202 W. First St. 90012, or e- mail kathy.kristof@latimes.com.