

August 15, 2002

Hon. Bill Lockyer  
Attorney General  
1300 I Street, 17<sup>th</sup> Floor  
Sacramento, California 95814

Attention: Ms. Tricia Knight  
Initiative Coordinator

Dear Attorney General Lockyer:

Pursuant to Elections Code Section 9005, we have reviewed the statutory initiative relating to the personal income tax (PIT) treatment of certain stock options (File No. SA2002RF0017). This measure would change the treatment of incentive stock options (ISOs) for purposes of the PIT's alternative minimum tax (AMT) and result in a reduction in revenues that are raised from the PIT.

## **Background**

*The PIT and AMT.* California levies a PIT on all income earned in the state and allows various income exclusions, deductions, and tax credits to be used to reduce the amount of tax that a taxpayer may owe. Under certain conditions, taxpayers who have claimed a large amount of deductions, exemptions, and other tax preference items in the determination of their regular PIT liability may be required to complete an AMT calculation.

The AMT procedure requires determining the taxpayer's "tentative minimum tax"—the calculation of which excludes or limits certain tax preference items. The tentative minimum tax is then compared to the regular PIT liability, with any excess of tentative minimum tax over the regular PIT liability representing the AMT. This AMT amount is added to the regular PIT liability resulting in total taxes owed. Taxpayers who pay an AMT in one year are allowed to claim a credit against the regular PIT in future years for certain amounts of tax paid pursuant to the AMT.

*Stock Option Plans.* There are two general types of stock option plans for tax purposes. Qualified stock option plans—also known as ISOs—qualify for certain types of preferential tax treatment. Nonqualified stock options have fewer restrictions and generally do not qualify for any special preferential tax treatment.

**ISO Plans.** In recent years, many companies have used ISOs as a component of compensation. These options are granted by employers to their employees, and allow employees to purchase stock at a specified price, regardless of the market value of the stock at the time the option is used or “exercised.” Employees exercise the ISO when the market price of the stock rises above the stock’s option price. Typically, companies require ISOs to be held for a minimum period of time before being exercised by the employee. Current law prohibits the granting of ISOs at a price below the market price at the time they are issued.

**Current Tax Treatment of ISOs.** Under the regular PIT, an employee may exercise the ISO to buy an employer’s stock without incurring any tax liability until the purchased stock is ultimately sold by the employee (which is allowed to occur at any time). The regular PIT is levied upon sale on the capital gain, representing the difference between the option price and the sales price. In California, unlike at the federal level, capital gains are taxed at the same rate as all other types of income.

While the exercise of an ISO stock *option* does not give rise to taxable income under the regular PIT, for purposes of California’s AMT, *the difference between the option price for the stock and the market price of the stock must be counted as income in the year that the option is exercised.* Thus, taxpayers would not owe any regular PIT as a result of exercising such stock options, but in certain circumstances they may owe the AMT as a result of such option activity. In some situations, the capital gain realized upon the sale of the stock may be insufficient to cover the AMT liability that was incurred earlier from the exercise of the stock option. This can occur in situations where the value of the stock has dropped below the price at which the ISO was exercised.

### **Provisions of the Initiative**

This statutory initiative amends state law to exclude from the AMT calculation any income resulting from the exercise of ISOs. Thus, the difference between the option price and the market price would not be considered income for AMT purposes. This change would result in a reduction in revenues stemming from the AMT. There would be some offsetting increases in revenues from the regular PIT in future years as the assets are sold. This is due to the fact that the AMT would no longer apply to exercised ISOs and thus no credits would be available in future years from the AMT on exercised ISOs.

The statutory initiative also amends state law to expand the amount of the AMT credit that can be taken in future years on options that have previously been exercised and subject to the AMT. As noted above, taxpayers are allowed to claim a credit for certain taxes paid in prior years pursuant to the AMT. This credit can generally be taken against the taxpayer’s regular tax liability but is limited by certain minimum tax requirements. The initiative amends this statute to exclude from this limitation AMT

paid in prior years as a result of the taxpayer's exercise of an ISO, thus expanding the amount of the credit available. Thus, the limitation would allow for a further reduction in tax liability below the regular PIT liability.

### **Fiscal Effect of the Initiative**

The fiscal impact of the initiative would depend on a number of different factors, including (1) the number of ISOs granted in the future, (2) the applicability of tax credits for AMT paid in prior years that can be claimed with respect to future years' tax liabilities, and (3) the performance of the equities market. Assuming that the measure is effective for the tax year 2004, we estimate that the reduction in state revenues in 2004-05 would likely be in the low hundreds of millions of dollars. The fiscal impact on state revenues would likely decline as the inventory of tax credits attributable to the AMT paid on ISOs is reduced.

*Summary of Fiscal Effect.* The measure would have the following major fiscal effect:

- **State Revenues.** First-year revenue reduction in the low hundreds of millions of dollars, with annual revenue losses declining somewhat in subsequent years.

Sincerely,

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Elizabeth G. Hill  
Legislative Analyst

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B. Timothy Gage  
Director of Finance