

IN THE UNITED STATES BANKRUPTCY COURT
FOR THE SOUTHERN DISTRICT OF TEXAS
HOUSTON DIVISION

IN RE:	§	
JAMES PAVLOSKY and	§	CASE NO. 05-31127-H2-13
DEBORAH THUMANN-PAVLOSKY,	§	
Debtor	§	
_____	§	
	§	
JAMES PAVLOSKY and	§	
DEBORAH THUMANN-PAVLOSKY,	§	
Plaintiffs	§	
vs.	§	ADVERSARY NO. 05-3350
	§	
UNITED STATE OF AMERICA (IRS),	§	
Defendant	§	

**MEMORANDUM FINDINGS OF FACT AND CONCLUSIONS OF LAW
RELATING TO JUDGMENT DISMISSING COMPLAINT WITH PREJUDICE**

James and Deborah Pavlosky (“Debtors”) filed this adversary complaint seeking a judgment against the United States (“IRS”) (i) determining that Debtors overpaid their 2000 and 2001 federal income taxes and (ii) awarding a refund of taxes allegedly overpaid for those years. The parties stipulated to the exercise of core jurisdiction by the bankruptcy judge, stipulated to the facts, and sought determination of the issues by cross motions for summary judgment. For reasons set forth below, the complaint is denied and dismissed with prejudice by separate judgment issued this date.

JURISDICTION

This is an adversary proceeding, a civil proceeding, arising in a case under title 11 and arising under title 11 of the United States Code. The United States District Court has jurisdiction under 28 U.S.C. § 1334(b) and (e) and Bankruptcy Code § 505. By Order dated August 9, 1984, superceded by General Order 2005-6 on March 10, 2005, under authority granted by 28 U.S.C. § 157(a), the United States District Court for the Southern District of Texas referred all such proceedings to the bankruptcy judges for the district. This is a core proceeding as defined by 28 U.S.C. § 157(b)(2)(A), (E). The bankruptcy judge

may hear and may determine core proceedings, 28 U.S.C. 157(b)(1). Both parties have stipulated that the bankruptcy judge has core jurisdiction.¹

STIPULATED FACTS AND COURT'S ANALYSIS

On December 20, 2000, Mr. Pavlosky exercised incentive stock options ("ISO") to purchase stock issued by his employer. He paid \$3.204 per share for 30,000 shares, a total purchase price of \$96,120. When the options were exercised, the stock was worth \$53.75 per share, a total value of \$1,612,500. Under §§ 55 and 56(b)(3) of the Internal Revenue Code ("IRC"), Debtors recognized income of \$1,516,380 for purposes of the Alternative Minimum Tax ("AMT") and paid an AMT tax liability of \$430,709 for 2000.

For purposes of calculation of the AMT in subsequent years, Debtors' "adjusted basis" in the stock is the amount that they paid for the stock plus the amount of ordinary income that is recognized on exercise of the ISO ($\$96,120 + 1,516,380 = \$1,612,500$).² Per share, Debtors' adjusted basis was \$53.75 ($\$1,612,500/30,000 = \53.75).

In 2001, Debtors sold 28,944 shares of the ISO stock purchased in 2000.³ The sales price was \$200,346.61. Debtor's adjusted basis for AMT purposes was \$1,555,740 ($\$53.75 * 28,944 = \$1,555,740.00$). Debtors loss on the sale for purposes of the AMT, therefore, was \$1,355,393.39 ($\$200,346.61 - 1,555,740.00 = (\$1,355.393.39)$).

PLAINTIFF'S CONTENTION

1. Debtors contend that legislative history indicates that "the amount included in alternative minimum taxable income will not exceed the amount realized on the sale or exchange of the stock over the adjusted basis of the stock."

On page 7 of their memorandum, Debtors quote a Senate committee report and a House committee report for that proposition. But Debtors fail to note that both reports limit that rule to situations in which the stock is sold in the same year in which the stock option is exercised. Both of the following quotes are taken directly from Debtor's memorandum as it cites that authority on page 7, but emphasis is added:

¹ Joint Stipulation of Facts, #2.

² IRC § 56(b)(3). For regular tax purposes, the adjusted basis is the amount that Debtors paid for the stock, \$96,200, IRC § 1012, but tax basis, gain, and regular tax liability is not at issue.

³ The additional 1,065 shares were sold in 2003, a year that is not at issue.

For example, if a taxpayer acquires stock pursuant to the exercise of an incentive stock option and disposes of the stock in the same taxable year, the tax treatment under the regular tax and the minimum tax will be the same...[from the Senate Report]

This bill clarifies the tax rules applicable ... where the stock is disposed of the same taxable year ... [from the House Report]

IRC § 422(c)(2) contains the “same taxable year” limitation and is adopted by IRC § 56(b)(3).

Since Debtors did not buy and sell their stock in the same taxable year, Debtors’ argument falls.

2. Debtors argue that the initial IRS form does not include a limitation of \$3,000 of annual deduction if capital losses exceed capital gains, and therefore IRC § 1211 does not apply to AMT NOL carrybacks. In paragraph 16 of their motion, Debtors argue that the IRS instructions that would apply § 1211 “... deny taxpayers their right to the AMT negative adjustment.”⁴

First, the Court notes that the earlier versions of the form do not state that the limitation does not apply. It simply does not state anything about § 1211.

More important, Debtors do not demonstrate a statutory right to a “negative adjustment”, other than an adjustment within the calculation of the tentative minimum tax for a given year. In paragraph 17 of the motion, Debtors seem to recognize that the “negative adjustment” relates to computations within the same taxable year.

IRC §§ 55 through 59 define AMT and the special adjustments to income for AMT purposes. The Court simply does not see any “negative adjustment” provision applicable to individuals that counteracts the rule in § 1211 limiting deduction of capital losses (net of capital gains) by individuals to \$3,000.

3. Debtors argue that IRS interpretation cannot be changed without Congressional approval.

Since the Court does not see the change that Debtors allege, the Court does not address the assertion.

SEPARATE TRANSACTIONS

⁴ Debtor’s motion for summary judgment, paragraph 16.

The Court agrees with the United States that *Arrowsmith v. Commissioner*, 344 US 6 (1952) does not apply. The exercise of the stock options was a different transaction from the sale of the stock, and had different origins. The stock was acquired in part, as compensation for services rendered. That transaction was completed when the stock was acquired. The taxpayer then began holding the stock for investment purposes, a separate transaction.

The loss occurred because it was held too long, while the market declined. The tax character of the loss was unrelated to the tax character of the income.

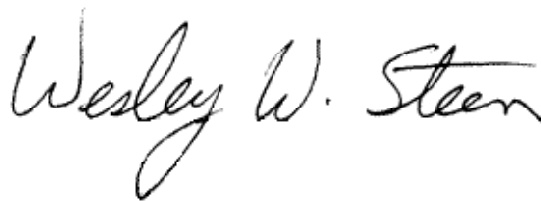
Debtors acquired 30,000 shares of stock in 2000 at a bargain price. The bargain was additional compensation for Mr. Pavlosky's employment. Debtors obtained stock valued at \$1,612,500 for \$96,120. The IRC does not impose "regular" tax on the bargain element of the purchase, but imposes an AMT on that additional compensation, to the extent that the AMT tax exceeds Debtors' "regular" tax.

Subsequent to exercise of the options, Debtors kept the stock, presumably hoping that the value would go up. If Debtors kept the stock for at least one year after exercising the option, they would be entitled to capital gains treatment on any gain. Holding the stock for investment is a different transaction from receiving the stock as additional compensation. Different tax rules apply, except when the purchase and sale occur in the same tax year; the statute explicitly provides for exceptional treatment in that situation, but not in any other.

CONCLUSION

For reasons set forth, judgment will be separately issued in favor of the government.

SIGNED June 1, 2006



WESLEY W. STEEN
UNITED STATES BANKRUPTCY JUDGE