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WEALTH MANAGEMENT

# The Complete Guide to Tax Strategies for ISOs and AMT Optimization

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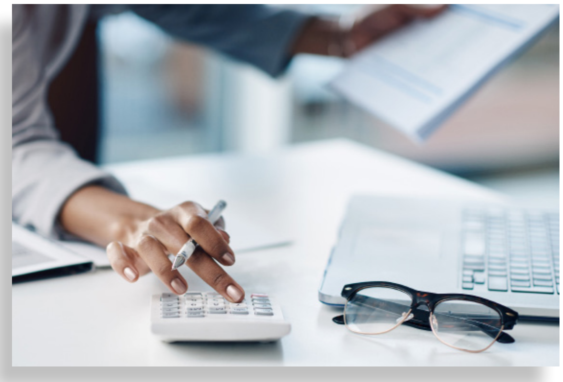
When you are exercising Incentive Stock Options (ISOs), it is essential to understand the implications of the Alternative Minimum Tax (AMT).



One of the most complex and least understood areas of the tax code, the AMT, was enacted in 1969 to prevent higher-income earners from paying too little tax because they were able to take a variety of deductions or exclusions.

A key factor for those deciding whether and when to exercise their ISOs is the impact and mitigation of the AMT. A lack of knowledge of how AMT works and how it can be managed can adversely impact your decision whether to Exercise and Hold or Sell (Same Day Sale) your ISO positions.

This guide takes you through some of the key AMT considerations when assessing the Hold versus Sell outcomes.

## [1] What Is the Alternative Minimum Tax?

AMT is a tax calculation that runs "in the background" to the regular tax calculation. All tax software runs AMT calculations on every return – however, you usually only see the AMT calculation when it results in an AMT liability that is in addition to the Regular tax liability.

As taxpayers must pay the higher of the calculated "AMT liability" and the "Regular liability," this can often be an unpleasant surprise.

**AMT includes more income items and allows fewer deductions than the regular tax calculation.**

With particular reference to ISOs, the difference between the Strike Price and the Fair Market Value (FMV) on an ISO exercise will give rise to AMT income (and can result in an AMT liability) in the year of exercise. This FMV-Strike Price is referred to as the ISO "Spread" and is not a taxable item for the Regular tax calculation.

- The AMT top rate of 28% is lower than the regular tax top rate of 37%
- For Californians, the state AMT rate is 7% compared to the regular top tax rate of 13.3%
- For New Yorkers, the state AMT rate is 6%

Source: IRS.gov

## [2] The Minimum Tax Credit

Where AMT tax is paid in one year, the amount of AMT paid is available to carry forward to offset against a future year's Regular tax liability. **An AMT Credit CANNOT be used to offset future years' AMT liability!** This AMT credit carryforward is referred to as the Minimum Tax Credit (MTC) and is computed on Form 8801.

The MTC may be used to reduce Regular tax liabilities in future years but ONLY when the Regular tax liability is higher than the calculated AMT liability. If the calculated AMT liability is higher than the Regular tax liability in the future year, the Minimum Tax Credit CANNOT be utilized in that year and must be carried forward to a tax year where the Regular liability exceeds the calculated AMT liability.

## [3] The Minimum Tax Credit

The three main triggers of AMT are:

1. Having high household income with a significant number of deductions
2. Realizing a large capital gain
3. Or most commonly, exercising Incentive Stock Options

**Looking solely at the stock option trigger, exercising ISOs and holding them into the next tax year can create AMT Income. The "in the background" AMT calculation then determines if there is any AMT tax due. In the AMT calculation, the Standard or Itemized Deduction available for Regular Tax purposes is replaced with a much larger AMT "Exemption Amount." This is favorable for taxpayers.**

The 2025 AMT Exemption Amounts are as follows:

| | You are ulikely to owe any AMT taxes if your AMT income is below the Exemption Amount | If total taxable income exceeds the "Phase-Out Thresholds," the Exemption Amount starts to reduce by $1 for every $4 that income exceeds the threshold |
|---|---|---|
| | **AMT Exemption Amount** | **AMT Income Phase-Out Thresholds** |
| **Single Individuals** | $88,100 | $626,350 |
| **Married Filing Jointly** | $137,000 | $1,252,700 |

Note that if AMT Income (including that generated by the ISO exercises) exceeds certain levels known as the "Phase-Out Thresholds," then the AMT Exemption Amount starts to be reduced by $1 for every $4 that Income exceeds the Phase-Out Threshold. The Phase-Out Threshold is $626,350 (Single) and $1,252,700 (MFJ).

The downside to the AMT Calculation is that AMT tax is, in large measure, applied at a Flat-Rate of 28% - the traditional marginal tax brackets available for the Regular Tax calculation are not available for the AMT calculation. Whether this downside will result in additional AMT tax to pay very much depends on the level of the AMT Income and the level and character of other taxable income in the year in question.

For these reasons, the only true way to calculate whether the AMT tax will apply in any particular year is to run a simulated tax return in advance for the year in question. Most CPA firms do not run these simulations and hence nasty surprises occur at tax time. At BakerAvenue we run these simulations in advance as a matter of course to anticipate these liabilities and adopt the appropriate mitigation and management strategies.

## [4] Taxation for ISOs Regular Tax vs. AMT Tax

The key to managing AMT and ISOs is to appreciate that the tax treatment between Regular tax and AMT tax, while radically different at the time of exercising the ISOs, is essentially a timing difference that is reversed when the ISO stock is subsequently sold.

At exercise of the ISO, the AMT income (and tax liability) will – all other things being equal – be greater than the Regular taxable income (and liability). When the stock is subsequently sold and the preferential Long-Term Capital Gains (LTCG) rate is applied to the disposal, the Regular taxable income (and liability) will (all other things being equal) be greater than the AMT income and liability – allowing the previously paid AMT tax to offset the Regular tax liability by virtue of the Minimum Tax Credit (MTC).

| Event | Regular Tax | AMT |
|---|---|---|
| Time of Grant | No Tax | No Tax |
| Time of Exercise | No Tax | AMT Income = FMV – Strike Price |
| Time of Sale | Gains = Proceeds – Strike Price | Gains = Proceeds – FMV at Exercise Date |

Because the AMT "Tax Basis" in the ISO stock was adjusted upwards to FMV at the date of Exercise, while the Regular "Tax Basis" in the ISO Stock remained at the Strike Price – a subsequent sale of the ISO Stock will essentially reverse the position at the time of Exercise and, critically, allow the previously paid AMT tax to offset the Regular tax liability by way of the Minimum Tax Credit.

The end result – if managed carefully – is that the ISO holder is able to **(1) Exercise the ISO options, (2) benefit from appreciation in the company stock price, and (3) enjoy the lower Long-Term Capital Gains tax rate of 20% on that appreciation** – with the knowledge that the AMT tax won't be an additional tax paid but is rather a temporary tax that can ultimately be recouped.

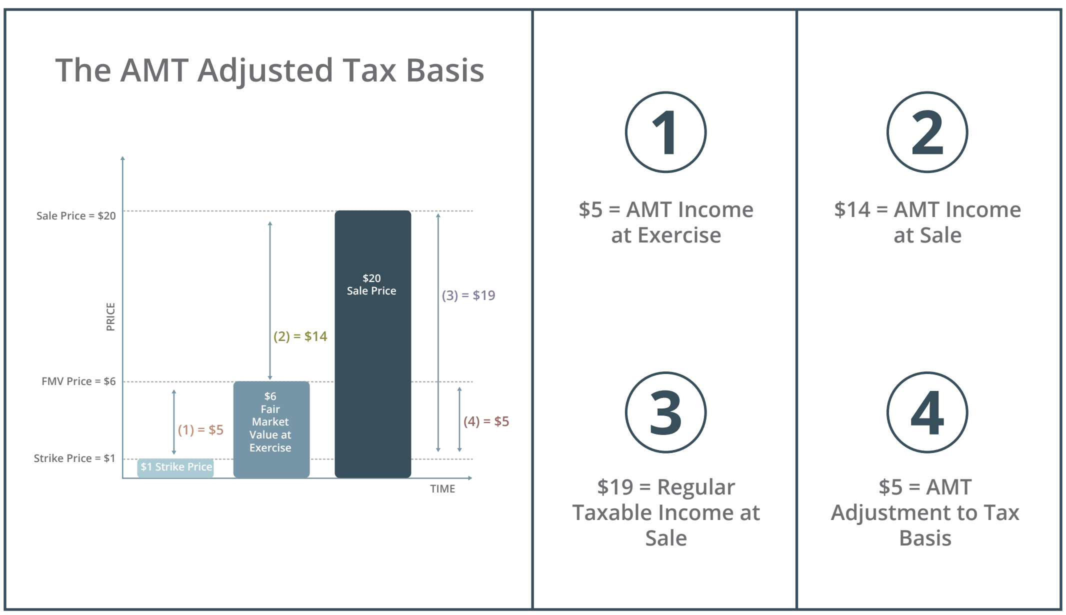
**The alternative to exercising your ISOs is an exit from the holding in the company at the highest marginal income tax rate.**

## [5] Benefits of the "Exercise and Hold and Manage AMT Strategy"

As a sample illustration, we'll follow a typical ISO transaction from exercise through final sale, and calculate what happens in four different scenarios.

**Assumptions:**

- ISO grant allowing purchase of 100,000 shares at exercise price of $1 per share
- FMV of shares at time of exercise is $6 per share
- Final Sale of shares takes place two years after exercise
- Taxpayer is at 20% LTCG and 28% AMT rates, and has no offsetting income, AMT exemptions/phaseouts or deductions other than this ISO transaction
- We disregard 3.8% net investment income tax to simplify tax rate at 20% for LTCG




For Illustrative Purposes. Source: [IRS.gov]

**Tax calculations:**

- Valuation spread at time of exercise is $5 per share (FMV – Exercise Price)
- Results in $500,000 of AMT Income while Regular tax income is $0 because ISO exercises are not subject to Regular tax

- In tax year of ISO exercise, $140,000 of AMT tax will be due using AMT rate of 28%
- Paying AMT also raises AMT Tax Cost Basis to $600,000 (100,000 x $6 FMV) whereas
- Regular Tax Cost Basis remains at exercise cost of $100,000 (100,000 x $1 Exercise Price)
  Results in $140,000 in AMT credit (Minimum Tax Credit) to be used in future tax year when taxpayer's Regular tax liability is higher than the AMT liability – the credit off-set is equal to the difference between these two calculated liabilities.

| | #1 Sale Price = FMV | #2 Sale Price > FMV | #3 Sale Price < FMV | #4 Sale Price < Exercise Price |
|---|---|---|---|---|
| Gross Sale Proceeds | $600,000 | $2,000,000 | $400,000 | $50,000 |
| Regular Tax Cost Basis | $100,000 | $100,000 | $100,000 | $100,000 |
| AMT Tax Cost Basis | $600,000 | $600,000 | $600,000 | $600,000 |
| AMT Credit | $140,000 | $140,000 | $140,000 | $140,000 |
| Regular Tax at Sale | $100,000 | $380,000 | $60,000 | $0 |
| AMT Tax at Sale | $0 on $0 income | $280,000 on $1,400,000 (AMT LTCG rate is also 20%) | $0 on $200,000 capital loss | $0 on $550,000 capital loss carry forward |
| AMT Credit | $100,000 credit utilized $40,000 carryover to future years | $100,000 credit utilized $40,000 carryover to future years | $60,000 credit utilized $80,000 carryover to future years | $0 credit utilized $140,000 carryover to future years |
| Final Tax on Sale | $0 | $280,000 | $0 | $0 |
| Cumulative Taxes Paid (1) | $140,000 | $420,000 | $140,000 | $140,000 |
| AMT Credit Carry Over (2) | $40,000 | $40,000 | $80,000 | $140,000 |
| Final Tax if Sale on Same Day Exercise @ 37% rate (3) | $185,000 | $703,000 | $111,000 | $0 |
| Max Tax Savings from Early Exercise (3)-(1)+(2) | $85,000 | $323,000 | $51,000 | $0 |

## [6] Conclusion

AMT is often described as a timing difference because of the ability to use in the AMT credit offset in future years. As illustrated above, the AMT credit reversal really depends on many contributing factors in the year of sale:

- The key to managing AMT for ISO exercises has two pillars: 1) use the AMT exemption amount and 2) utilize the AMT credit in the tax years subsequent to the exercise
- The AMT credit can only be utilized in these subsequent years when the Regular tax liability is greater than the AMT liability – the AMT credit does NOT off-set an AMT liability
- The bigger the “gap” between the Regular tax liability and the AMT liability in these years, the more AMT credit can be utilized
- Because the AMT tax basis in ISO stock exceeds the Regular tax basis, the most effective way to widen the “gap” is often to sell the ISO stock after it qualifies for the Long Term Capital Gains preferential tax rates.

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