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Working with the Wealthy

Timing Matters for ISOs and AMT

By: Holly Swan | February 7, 2024

During tax season, you can be of great value to clients even though you're not a tax professional. This is especially true for your clients who receive employer stock. When it comes to incentive compensation, remember:

1) Let the tax code be your guide

2) Timing matters

The IRS' instructions for determining the alternative minimum tax (AMT) on IRS Form 6251 are mind-numbing, so let's break it down in plain speak. Put simply, the AMT adds certain items back to income to ensure wealthy taxpayers pay what the tax code believes to be their fair share. One of these items relates directly to incentive stock options (ISOs).

The bargain element, the total discount received when options are exercised to buy stock at a below-market price, is considered income for AMT purposes for any ISOs exercised during the year. That amount can be considerable, even though a client still holding the shares hasn't received any cash.

Here are two considerations to bring up in conversations with clients about ISOs:

1. Consider exercising over multiple years. The conventional wisdom regarding options is that exercising well in advance of expiration wastes leverage and spends time value. That may be true for other kinds of options, but ISOs are different because they're an AMT preference item—the bargain element (discount) must be added to income when calculating AMT. Clients with multiple tranches of ISOs—or even a single large tranche—may want to spread their exercise over several years to avoid triggering AMT in any one year.
2. A client exercising ISOs early in the year has "options" (pun intended). Stock acquired through exercising an ISO that's disposed of in the same year isn't an AMT preference item. Exercising an option early in the year will give clients time to decide if they would benefit from holding the shares or selling before year-end. For instance, if the stock price stays the same or rises over the course of the year, an employee may wish to keep the shares and pay AMT in the same year. That way a long-term gain can be realized in the future. Then they can potentially receive an AMT credit when they sell the shares.

The employee could also choose to sell the shares and eliminate the prospect of AMT if the stock declines considerably before year-end. The employee would have a short-term capital gain or loss in this situation, which may be preferable to AMT.

Connect with clients about their latest equity awards and be sure to ask about vested ISOs. Their unique tax treatment makes them great candidates for exercising early in the calendar year to preserve flexibility, and staged over several calendar years to reduce the likelihood of triggering AMT.

Bottom line: The start of a new year is the time to discuss ISOs with your clients.

The Firm does not provide tax advice. The tax information contained herein is general and is not exhaustive by nature. Tax laws are complex and subject to change. Investors should always consult their own legal or tax professional for information concerning their individual situation.

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