Recent Congressional Fix to the ISO AMT Tax Trap

Introduction

Stock options grant the holder the right to acquire a fixed amount of stock at a fixed price (called the "strike price") during a specific time frame. When an employee exercises incentive stock options (ISO), the employee pays the strike price to the company and, in turn, receives the company's stock.

For example, if the company's stock is worth $1.00 per share and the strike price is a penny a share when a stock option is exercised, the "spread" is 99 cents a share. Thus, the employee receives stock worth $1.00/share by paying just a penny a share.

ISOs

During the glory days of the high tech boom, ISOs were generously distributed to employees throughout the workforce. When an ISO is exercised, the employee does not pay tax under the regular tax system, but the spread is a "preference", subject to Alternative Minimum Tax (AMT). Using the above example, the spread of 99 cents per share is the tax preference under the AMT. If the stock subsequently declined to 2 cents a share, AMT is still calculated on the 99 cents per share spread.

AMT Credits

In theory, AMT arising from the exercise of ISOs functions as a "prepayment" of the eventual tax due when the stock is sold. Consequently, taxpayers receive an AMT credit generally equal to the amount of AMT paid. Unfortunately, the current federal long-term capital gains rate (LTCG) under the regular system is 15% while the highest AMT rate is 28%, which means the AMT could be as much as 13 percentage points higher.

For example, if a taxpayer exercises ISOs and the spread is $100 per share, under the AMT, the tax could be as high as 28%. The taxpayer would receive a $28 per share AMT credit. On a later sale of the stock for $100 per-share gain (assume LTCG), the federal tax would be 15% or $15.00 which means the taxpayer would have unused AMT credits of $13.00/share.

If the stock plummeted to $2.00/share, which happened to thousands of taxpayers invested in their company's stock, the federal 15% LTCG rate produces a tax of $.30 a share and the unused AMT credits will be $27.70/share.

In either case, the taxpayer will have paid substantially more tax under the AMT than under the regular system and will be saddled with potentially unusable AMT credits.

Solution

After years of lobbying by reformamt.org, an organization comprised of thousands of taxpayers burned by the ISO/AMT tax trap, Congress finally addressed this anomalous result in late 2006 when it passed legislation to allow certain taxpayers who have unused AMT credits to claim a refundable credit at 20% of the long-term unused AMT credits per year for the next five years.

In general, a taxpayer with, for example, $1,000,000 in AMT credits will have an opportunity to receive approximately $200,000 per year for the next 5 years, starting in tax year 2007 and ending on December 31, 2012.

Phase-outs

Unfortunately, what Congress gave with one hand, it took back, to a large extent, with the other. Those with incomes exceeding certain adjusted gross income (AGI) threshold amounts will have their credits reduced or eliminated. This determination is made on a year-by-year basis. For joint filers, the phase-out begins at $234,600 and ends at $457,100. For single filers, the phase-out begins at $156,400 and ends at $278,900.

> Note: Capital gains are included in AGI and itemized deductions do not reduce AGI, so these threshold amounts could be reached much quicker than anticipated.

Conclusion

The ISO/AMT legislation will allow taxpayers AMT credits to recover them over a five-year period, as long as their AGI falls below the phase-out amounts. While the legislation does not address situations where taxpayers could not pay the initial AMT and incurred large penalties and interest charges, it is a first step in the process of fixing a major glitch in the tax code that caused substantial financial harm to thousands of taxpayers.