## Chapter 8. ESOs - AMT Complications:

The gain at the exercise date of an ISO is a tax preference item for purposes of calculating AMTI. That is, the gain is added (with other applicable items) to regular taxable income and the taxpayer pays the excess AMT if the AMT exceeds the regular tax due. The taxpayer receives a credit for the AMT paid in later years when regular tax exceeds the AMT.

Thus in the year of exercise, if the taxpayer pays the AMT the amount of tax due is

$$(P_e - X)t_{amt} \quad (1)$$

and when the stock is subsequently sold the net tax due is[1]

$$(P_s - X)t_{cg} - (P_e - X)t_{amt} \quad (2)$$

Thus the total tax due is (1) + (2) = $(P_e - X)t_{amt} + (P_s - X)t_{cg} - (P_e - X)t_{amt}$

$= (P_s - X)t_{cg}$

which equals the tax due in the absence of the AMTI. However, the AMTI accelerates some of the total tax to the exercise period.

**Numerical Examples for AMT effects on ISO Tax Treatment.**

Assume the following facts: $t_p = 30\%$, $t_{amt} = 28\%$, $t_{cg} = 20\%$

| | Year | | | | |
|---|---|---|---|---|---|
| | 1 | 2 | 3 | 4 | 5 |
| Regular salary | $140,000 | $140,000 | $140,000 | $140,000 | $140,000 |
| Regular tax @30% | $42,000 | $42,000 | $42,000 | $42,000 | $42,000 |
| | | | | | |
| Stock price | $10 | $15 | $25 | $45 | $50 |
| ISO | Grant | | Exercise | Sell stock | |

In year 1 and 2 pay the regular tax of $42,000 on the $140,000 salary. Note we are assuming here a flat tax rate of 30% on ordinary income (and thus are ignoring personal exemptions, and progressiveness in the personal tax rate schedules). If there were no AMT, then the total tax due on the ISOs is ($45-$10)10,000x.20 = $70,000 when the stock is sold in period 4.

In year 3, the employee exercises the ISO. Because they are ISOs, regular tax remains at $42,000. However the AMTI adds the ISO gain of $150,000 [($25 - $10)10,000] to regular taxable income for a total AMTI of $290,000. Assuming a flat AMT tax rate of

[1] It is extremely important to note we are assuming here that the entire gain at the exercise date is subject to AMT and that in the year of the sale the employee receives a full credit for the previously paid AMT. In practice, both assumptions are likely false – so while the algebra allows some simplification here is a case where caution is warranted in using the algebra. Numerical examples below highlight the shortcomings of the algebraic approach here.

28% gives an AMT of $81,200. Thus the employee pays total taxes of $81,200 consisting of $42,000 in regular tax and $39,200 in AMT.

In year 4, the employee sells the stock. Regular tax is calculated as $42,000 on salary plus 20% on the long-term capital gain of $350,000 [($45-$10)10,000] = $70,000 for a total regular tax of $112,000. The AMT can be calculated two ways. First, regular income of $140,000 + $350,000 = $490,000 less the difference in the regular and AMT tax bases of the stock sold. For regular tax, the basis is $100,000 (10,000 x $10) and for the AMT it is $250,000 (10,000 x $25). This gives an AMTI of $340,000. An alternative calculation is simply to add the AMT ISO gain to regular taxable income: $140,000 + $200,000 [$45 - $25)10,000] to give $340,000. The AMT then at 28% is $95,200, which is $16,800 less than the regular tax due. Thus the employee can take an AMT credit of $16,800 to reduce taxes from $112,000 to $95,200 in year 4. Thus tax on regular salary was $42,000 and total tax was $95,200 so the incremental tax due to the ISO less the AMT tax credit is $53,200.

To summarize

| | Year | | | | |
|---|---|---|---|---|---|
| | 1 | 2 | 3 | 4 | 5 |
| Regular salary | $140,000 | $140,000 | $140,000 | $140,000 | $140,000 |
| Regular tax @30% | $42,000 | $42,000 | $42,000 | $42,000 | $42,000 |
| | | | | | |
| Stock price | $10 | $15 | $25 | $45 | $50 |
| ISO | Grant | | Exercise | Sell stock | |
| If no AMT | | | | | |
| Gain | | | | $350,000 | |
| Tax | | | | $70,000 | |
| With AMT | | | | | |
| Gain | | | $150,000 | $200,000 | |
| AMT tax | | | $39,200 | $53,200 | |

The net tax due under the AMT system is $39,200 + $53,200 = $92,400 which is $22,400 greater than regular tax on the ISOs.

Why?
The AMT calculation in year 4 leads us to receiving less than full credit for the previously paid AMT. Why did we receive less than full credit? The amount of the credit is the difference between the regular tax and AMT tax:

| | **Regular tax** | **AMT** | **Difference = AMT credit** |
|---|---|---|---|
| Year 4 | | | |
| Salary | $140,000 x .30 = $42,000 | $140,000 x .28 = $39,200 | |
| ISO | $350,000 x .20 = $70,000 | $200,000 x .28 = $56,000 | |
| | $112,000 | $95,200 | $16,800 |

In calculating the AMT amount we apply a 28% rate on the gain compared to a 20% rate on the gain for regular tax purposes (because it is a long-term capital gain). Thus the difference in the two taxes, regular vs. AMT is smaller in the stock sale year and thus the taxpayer will receive in this case less than full credit for the previous taxes paid on the exercise of the ISO. The full credit would be $39,200 but the actual credit is $16,800, a difference of $22,400. These excess AMT tax credits can be carried forward but it is unlikely that the taxpayer will be able to fully utilize them.

**What happens if the taxpayer's marginal tax rate on ordinary income is 40% (compared to 30% above)?**

| | **Regular tax** | **AMT** |
|---|---|---|
| Year 3 | | |
| Salary | $140,000 x .40 = $56,000 | $140,000 x .28 = $39,200 |
| ISO | $0 | $150,000 x .28 = $42,000 |
| | $56,000 | $81,200 |
| | | |

Pay excess AMT of $25,200. Why is the AMT smaller here? (Regular tax higher because higher regular tax rate.)

| | **Regular tax** | **AMT** |
|---|---|---|
| Year 4 | | |
| Salary | $140,000 x .40 = $56,000 | $140,000 x .28 = $39,200 |
| ISO | $350,000 x .20 = $70,000 | $200,000 x .28 = $56,000 |
| | $126,000 | $95,200 |
| | | |

Regular tax exceeds AMT by $30,800 which also exceeds the AMT credit available from year 3 of $25,200. Thus take full AMT credit of $25,200 to reduce taxes due to $100,800.

**What happens if the stock price drops in year 4 before we sell the stock?** We consider two cases, a stock price of $20 which is less than the exercise date stock price, and a stock price of $5 which is less than the option exercise price.

*Stock price at sale date of $20.* How much taxes are due and how much AMT tax credit does the taxpayer receive?

| | **Regular tax** | **AMT** |
|---|---|---|
| Year 4 | | |
| Salary | $140,000 x .30 = $42,000 | $140,000 x .28 = $39,200 |
| ISO | $100,000 x .20 = $20,000 | ($50,000) x .28 = ($14,000) |
| | $62,000 | $25,200 |
| | | |

Gain for regular tax = (20 – 10)10,000 = $100,000
Gain for AMT = (20 – 25)10,000 = ($50,000).
Excess of regular tax over AMT = $36,800.
Total tax is $62,000 – $36,800 AMT tax credit = $25,200 tax payable with $39,600 - $36,800 = $2,800 AMT credit carryforward.

*Stock price at sale date of $5.* How much taxes are due and how much AMT tax credit does the taxpayer receive?

| | **Regular tax** | **AMT** |
|---|---|---|
| Year 4 | | |
| Salary | $140,000 x .30 = $42,000 | $140,000 x .28 = $39,200 |
| ISO | ($50,000) x .20 = ($10,000) | ($200,000) x .28 = ($56,000) |
| | $32,000 | (16,800) |
| | | |

Gain for regular tax = (5 – 10)10,000 = ($50,000)
Gain for AMT = (5 – 25)10,000 = ($200,000).

Excess of regular tax over AMT = $32,000 – ($16,800) = $48,800.
Total tax is $32,000 – $32,000 AMT tax credit = $0 tax payable with $39,200 - $32,000 = $7,200 of AMT credit carryforward.

**Tax planning when stock price drops after exercise before end of tax year.**

Now consider the case that in the exercise year the stock price drops below the stock price on the exercise date – here $P_e$ = \$25. Should the taxpayer continue to hold the stock and pay the AMT or should the taxpayer sell the stock (a disqualifying disposition) and pay tax as-if the ESOs were NQOs.

Suppose stock price drops to \$20.

| | **Pay AMT** | **Disqualify by early sale $t_p$ = .30** | **Disqualify by early sale $t_p$ = .40** |
|---|---|---|---|
| Salary | \$140,000 x .28 = \$39,200 | \$140,000 x .30 = \$42,000 | \$140,000 x .40 = \$56,000 |
| ESO | \$150,000 x .28 = \$42,000 | \$100,000 x .30 = \$30,000 | \$100,000 x .40 = \$40,000 |
| | \$81,200 | \$70,000 | \$96,000 |
| | | Thus disqualify | Thus do not disqualify |

ESO gain if disqualify = (\$20-\$10)10,000 = \$100,000.

Suppose stock price drops to \$15.

| | **Pay AMT** | **Disqualify by early sale $t_p$ = .30** | **Disqualify by early sale $t_p$ = .40** |
|---|---|---|---|
| Salary | \$140,000 x .28 = \$39,200 | \$140,000 x .30 = \$42,000 | \$140,000 x .40 = \$56,000 |
| ESO | \$150,000 x .28 = \$42,000 | \$50,000 x .30 = \$15,000 | \$50,000 x .40 = \$20,000 |
| | \$81,200 | \$57,000 | \$76,000 |
| | | Thus disqualify | Thus disqualify |

ESO gain if disqualify = (\$15-\$10)10,000 = \$50,000.