Are Incentive Stock Options Dead?

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Because gain attributable to incentive stock options (ISOs) is subject to the alternative minimum tax, the apparent tax advantage is lost. As a result, companies may decide to use only non-ISOs.

Stock options have long been an important feature of many companies' executive compensation programs, but with the adoption of Financial Accounting Standard No. 123(R), much has been written about their impending death. However, options continue to be an important, if not a primary, vehicle for performance-based executive compensation. Their appeal is due in part to the favorable tax treatment some of them receive under the code. But the future viability of incentive stock options (ISOs) is brought into question by the growing reach of the alternative minimum tax, with more taxpayers subject to the AMT every year. The expansion of the AMT is cause for concern because ISOs are not given the favorable tax treatment under the AMT that they are under the regular tax system. Therefore, in the coming years, executives with ISOs are likely to receive greater exposure to the AMT and a consequent increased tax liability. This suggests that the appeal of ISOs will diminish and that their use as executive-based compensation may decline.

This article will first describe how ISOs work and then show the disadvantages of ISOs under the AMT tax regime. It then lists other reasons ISOs are unappealing. Finally, it suggests that ISOs should be abandoned in favor of non-ISOs because of those AMT problems and other reasons.

The world of stock options is arguably divided into two parts: nonqualified, nonincentive stock options governed by section 83, and incentive stock options governed by section 422. In many situations companies have adopted ISO programs because of the apparent tax benefits they provide to executives.

Those apparent tax benefits are important. The executive recognizes no income when an ISO is granted or exercised.[1] Thereafter, if the executive satisfies the ISO holding period, all the gain recognized from the sale of ISO stock will enjoy the current 15 percent capital gains tax rate.[2] That gain, of course, is measured by the difference between the amount realized from a sale and the adjusted basis in that ISO stock, which is equal to the option exercise price.[3]

The holding period for an ISO imposes two requirements: The executive must hold the stock (1) for two years from the date of grant of the ISO, and (2) one year from the date shares were transferred to the executive under the exercise of the ISO.[4] A sale of the stock that takes place before that holding period is satisfied — that is, a disqualifying disposition — results in ordinary income for the executive.[5] This ordinary income is measured by the difference between the option exercise price and the fair market value of the shares when the option was exercised, or the difference between the exercise price and the amount realized on a disposition of those shares, whichever is less. The executive option holder will then recognize either long-term or short-term capital gain or loss depending on whether the shares are held for more or less than 12 months from exercise for any additional gain realized on that sale.[6]

That beneficial treatment of ISOs does not apply under the AMT, however.[7] In calculating a taxpayer's alternative minimum taxable income, the AMT regime includes ISOs in its ''adjustments'' — those items that the AMT takes into account when calculating overall tax liability,[8] but which the regular tax does not. Taxpayers are required to include in AMTI the difference between the FMV of the stock on the date of exercise less the exercise price.[9] In short, the regular tax gives taxpayers with ISOs a break, but the AMT does not.

A simple numerical example will demonstrate the advantages of an ISO under the regular tax compared with the detrimental effect of potential AMT liability.

Assume:

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[1]Section 421(a)(1). *See also* reg. section 1.421-2(a)(1)(i).

[2]If an executive satisfies the ISO holding period, he will have held the stock for more than a year, which is the length of time required to merit long-term capital gains treatment. Section 1222(3).

[3]*See* section 1001(a). (''The gain from the sale or other disposition of property shall be the excess of the amount realized therefrom over the adjusted basis provided in section 1011 for determining gain.'')

[4]Section 422(a)(1).

[5]Reg. section 1.421-2(b)(1)(i). The regulations provide that in a disqualifying disposition, section 83(a) shall apply to determine the amount includable in gross income. *Id.* Section 83(a) states that the amount includable in gross income shall be the FMV of the property when it becomes substantially vested less the amount paid for the property. Section 83(a).

[6]*See* section 1222.

[7]*See* section 56(b)(3). (''Section 421 shall not apply to the transfer of stock acquired pursuant to the exercise of an incentive stock option (as defined in section 422).'') In essence, the AMT treats an ISO as though it were a nonqualified stock option governed by section 83. *See Merlo v. Commissioner*, 126 T.C. 205, 209 (2006), *Doc 2006-7878, 2006 TNT 80-4*.

[8]*See* section 55(b)(2)(A); section 56(b)(3) (stating that under the AMT, ISOs do not receive the treatment specified by section 421, which provides in part that no income is recognized on exercise of an ISO).

[9]Section 83(a).

1. Exercise price of option	$10x
2. FMV of stock at exercise	$100x
3. FMV of stock at sale	$150x

If the executive exercises the option and holds the stock for the required ISO holding period, he will realize no regular tax at exercise. When he sells the stock, he will realize $150x-$10x = $140x of taxable gain. This will be taxed at the current 15 percent capital gains rate, generating $21x of tax.

However, if the executive sells the stock as part of a disqualifying disposition, that is, before the ISO holding period is satisfied, he will again realize no regular tax at exercise. But the difference between the FMV of the stock at exercise and the exercise price of the option will be taxed as ordinary gain. That means that the executive will have $100x - $10x = $90x of ordinary gain, creating a tax liability of $31.5x.[10] Also, the difference between the FMV of the stock at the time of sale and the FMV of the stock at exercise will be taxed at the 15 percent capital gains rate.[11] Therefore, the executive will have $150x - $100x = $50x of capital gains income, which yields a tax of $7.5x. In total, a disqualifying disposition would create a tax liability of $39x in this example.[12] That amount is nearly double that of the tax imposed when the executive satisfies the holding period requirements. Therefore, the cost of a disqualifying disposition is severe.

The tax consequences that result when an executive is subject to the AMT are also unappealing. The AMT imposes a 28 percent tax rate at the time of the ISO exercise.[13] The executive will be taxed immediately on the gain measured by the difference between the option price and the FMV of the stock at the time of exercise. This will result in a gain of $100x - $10x = $90x, which at the 28 percent AMT rate will yield tax in the year of exercise of $25.2x. The basis in the stock will increase to $100x. That basis adjustment, of course, applies only to AMT calculations; it does not affect the calculations regarding the regular tax.

A significant consequence of the AMT at the time of exercise is that the executive must pay a tax on a gain that exists only on paper. In other words, the money he must use to pay the tax does not come from any cash he has from the sale of the stock. Because the stock has not been sold, the money to pay the tax must of necessity come from some other source. Although some executives may have ready cash to pay tax debts, there are others who will not, particularly in the case of a large ISO exercise.[14] Those who can afford to pay the AMT on exercise may view it as an inconvenience. But for those who cannot afford to do so, an ISO loses all utility. If the executive has to sell the stock to get cash to pay the AMT at exercise, then one of the chief benefits of an ISO — retaining an equity interest in the company in the hope that it appreciates over time — is lost.[15]

When the executive sells the stock, he will recognize a gain equal to the FMV of the stock at the time of sale less the adjusted basis. In the example above, this produces a $150x - $100x = $50x gain for AMT purposes, the tax on which will be $11x.[16] Adding together the tax at exercise and the tax at sale results in a total AMT liability of $36.2x — nearly as large as a mere disqualifying disposition of ISO stock. The harshness of this result is increased because the employer corporation does not get a tax deduction in connection with its ISO program unless there are disqualifying dispositions.[17] Also, under FAS 123(R), there is a compensation expense for generally accepted accounting principle purposes. Under the AMT, the apparent tax advantage of an ISO vanishes.

Accordingly, the results seem to be the following: (1) the use of a non-ISO with ultimate sale of the stock produces a tax of $39x; (2) the same $39x results from the use of an ISO with a disqualifying disposition; and (3) an ISO that satisfies the holding period requirements produces a total AMT liability of $36.2x. The use of an ISO without the AMT produces the best result, $21x of tax,

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[10]This example assumes that the gain realized by the hypothetical executive is subject to the 35 percent income tax rate. So this also represents the tax arising from the use of a non-ISO.

[11]This example, of course, assumes that the executive has met the one-year holding period for long-term capital gains treatment of the gain, despite not having met the ISO holding period rules.

[12]This also represents the full tax arising from a non-ISO for the gain from exercise and the additional capital gain from the later sale of the stock.

[13]Section 55(b)(1)(A)(i). The AMT calculates a noncorporate taxpayer's tentative minimum tax by imposing a 26 percent rate on the first $175,000 of taxable excess and a 28 percent rate on any taxable excess greater than $175,000. *Id*. This example assumes the executive has sufficient income from other sources that causes his taxable excess to exceed $175,000 and to subject the gain realized by the option exercise to the 28 percent AMT rate instead of the 26 percent rate.

[14]*See, e.g.*, *Chou v. Commissioner*, T.C. Memo. 1990-90 (RIA) 2007-102, *Doc 2007-10381, 2007 TNT 81-7*. Mr. Chou held approximately 153,000 ISOs of Cisco Systems. In 2000 he exercised 106,560 of his ISOs when Cisco's stock was trading at $64.69 per share. In preparing his tax return for that year, Mr. Chou stated a tentative AMT liability of $1,962,365 resulting from the exercise of the ISOs. Unfortunately for Mr. Chou, by April 2001, Cisco's stock had fallen to $17.64. Because of the AMT on ISOs at exercise, Mr. Chou's total tax liability for the year 2000 was greater than the amount he could obtain if he sold all the shares he had acquired in the ISO. In 2003 the IRS sent Mr. Chou a letter stating that his tax liability for the year 2000 was then $2,703,152.90. Cases like Mr. Chou's demonstrate the hardship that some taxpayers encounter when they do not have cash on hand to pay the AMT in the year of the ISO's exercise.

[15]While many of those tax consequences also apply to nonincentive stock options, for example, tax on a gain that exists only on paper, the results are expected and anticipated with nonincentive stock options when cashless exercise programs exist to address the resulting tax liability.

[16]Although long-term capital gains are taxed at 15 percent under the AMT, the presence of those gains reduces a taxpayer's exemption from the AMT, resulting in an effective rate of 22 percent on long-term capital gains for taxpayers at the highest AMT rate of 28 percent. *See* Greg Leiserson, *The 15 Percent Rate on Capital Gains a Casualty of the Alternative Minimum Tax*, Tax Policy Center, Mar. 7, 2007, *available at* http://www.taxpolicycenter.org/publications/url.cfm?ID=901052.

[17]Of course, with a nonincentive option program, the employer always gets a deduction at the time of exercise equal to the income realized by the executive.

but that will rarely occur because of the widespread application of the AMT as explained below.

To make matters worse, every year the AMT affects a greater number of taxpayers. There are two principal reasons for this: inflation and the tax cuts enacted under President George W. Bush.[18] Because the AMT is not indexed for inflation, the income range it captures remains constant. But as incomes rise gradually under the effect of inflation, more taxpayers fall within the reach of the AMT. That process has been termed ''downward creep.''[19] In 2000 the AMT affected 1.1 million taxpayers, but in 2010, that number is expected to rise to 27 million,[20] and will most likely apply to those with incomes between $200,000 and $500,000.[21]

The Bush tax cuts have exposed more taxpayers to potential AMT liability because the cuts were aimed at reducing regular income taxes; they affected the AMT only slightly.[22] For a taxpayer whose AMT liability exceeds his regular tax liability, the Bush tax cuts have widened the gap between the two, causing the AMT to constitute more of his overall tax liability.[23] The Tax Policy Center estimates that in 2007, of the 23.4 million taxpayers affected by the AMT, only 10.2 million would have been affected in the absence of the Bush tax cuts.[24]

Many commentators and scholars have argued for the modification of the AMT, or even its outright repeal. Although there may be many reasons why Congress has seen fit only to tinker periodically with the AMT, there is one powerful force delaying any substantive change to the AMT: its revenue-generating capacity. In a 2005 hearing before the Senate Finance Subcommittee on Taxation, IRS Oversight, and Long-Term Growth, Douglas Holtz-Eakin, then-director of the Congressional Budget Office, stated that the repeal of the AMT would cost the Treasury $600 billion over the next decade.[25] In 2007 *The New York Times* reported that repealing the AMT would cost the government $70 billion in that year alone, while repealing the regular tax and subjecting everyone to the AMT would cost less: $63 billion.[26]

Partial measures short of repeal would also reduce the revenue created by the AMT. The CBO estimated in 2005 that billions of dollars would be lost over the course of a decade if the AMT were modified to restrict its reach.[27] The costs of repeal or careful alteration may cause Congress to hesitate and delay action until reform can no longer be postponed. Some authors, however, suggest that the growing effect of the AMT — its consequent burden on taxpayers it was never intended to touch — will prompt Congress to make substantive changes to the tax code.[28] That has not happened. At some point Congress may alter the AMT. For the moment, however, it appears that the AMT will not go away, but instead will incrementally affect more taxpayers.

That raises the obvious question of why bother with ISOs, which only seem to result in a very small, negligible benefit if the AMT applies. For many years, larger public companies that were interested in and could use the tax deductions attributable to the exercise of non-ISOs have typically forgone ISO programs. However, smaller loss companies have often decided that because the stock option tax deduction is of little current value, an ISO program should be adopted. The foregoing analysis of the increased tax liability that the AMT imposes on ISOs raises serious questions about that approach. But there are other reasons why ISO programs have lost favor. Modern trends, as well as the application of section 409A, will require ISO and non-ISO programs:

- to use an option price not less than the FMV of the stock at the time the option is granted[29]; and
- to have the stock option program approved, perhaps on a regular basis, by shareholders.[30]

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[18]William G. Gale et al., Tax Policy Center, ''Options to Fix the AMT 6'' (2007), *available at* http://www.brookings.edu/views/papers/gale/20070119.pdf.

[19]Michael D. Kim, ''The Downward Creep: An Overview of the AMT and Its Expansion to the Middle Class,'' 6 *DePaul Bus. & Comm. L.J.* 451, 463 (2007-2008).

[20]Steven Maguire, ''Alternative Minimum Taxpayers by State: 2006, 2007 and Projections for 2010,'' Congressional Research Service.

[21]Kim, *supra* note 19, at 460.

[22]Gale et al., *supra* note 18, at 6.

[23]*See id.* at 2. (''Anything that reduces the regular income tax relative to the AMT or that increases the tentative AMT relative to the regular income tax will move taxpayers onto the AMT, and vice versa.'')

[24]*Id.* at 6.

[25]''The Individual Alternative Minimum Tax: Hearing Before the Subcomm. on Taxation and IRS Oversight of the S. Comm. on Finance,'' 109th Cong. 7 (2005) (statement of Douglas Holtz-Eakin, Director, Congressional Budget Office).

[26]David Cay Johnston, ''The Untaxed Rich, Found and Then Lost,'' *The New York Times*, Mar. 4, 2007.

[27]''The Individual Alternative Minimum Tax: Hearing Before the Subcomm. on Taxation and IRS Oversight of the S. Comm. on Finance,'' *supra* note 25. In particular, Holtz-Eakin stated that over the period 2006-2015, $385 billion would be lost if the 2005 AMT exemptions were made permanent and, along with all other AMT parameters, were indexed for inflation thereafter. Allowing personal and dependent exemptions under the AMT, as under the regular tax, would reduce revenues by $343 billion over the same period. Allowing state and local tax deductions would reduce revenues by $423 billion, and allowing the standard deduction would reduce revenues by only $64 billion.

[28]*See* Jonathan Weisman, ''Falling Into Alternative Minimum Trouble,'' *The Washington Post*, Mar. 7, 2004, at F9. Weisman apparently expected that congressional action on the matter would occur within a few years. His argument states that the inequitable effect of the Bush tax cuts, combined with record spending deficits, would require the overhaul of the tax code and the federal budget. Weisman focuses on the expansion of the AMT, which was partially occasioned by the Bush tax cuts, and states that when the AMT was initially enacted, Congress probably did not intend for it to affect ''a reporter and his editor wife.'' *Id*.

[29]As a result of section 409A, which requires the inclusion in gross income of deferred compensation under nonqualified deferred compensation plans, discounted stock options of any type are no longer permitted. *See* section 409A(a).

[30]Section 422(b)(1); reg. section 1.422-3. (''The approval of stockholders must comply with all applicable provisions of the corporate charter, bylaws, and applicable State law prescribing the method and degree of stockholder approval required for the issuance of corporate stock or options.'')

Also, ISOs are more difficult to administer. There are several complexities associated with ISOs that can be avoided if non-ISOs are used:

- three months following termination of employment the apparent ISO benefits are lost[31];
- the $100,000 investing limitation effectively limits the size of ISOs that may be granted to any one employee[32];
- net exercise or stock appreciation right features are not available for the exercise of an ISO[33];
- additional tax reporting is required whereby a special statement must be sent to an executive exercising an ISO in addition to the W-2 otherwise required; and
- ISOs are available only to employees, not to consultants.[34]

Based on the foregoing and in light of the severe negative effect of the widely applicable AMT, a strong argument can be made that everyone should abandon ISOs. That would assure the company a regular income tax deduction at the time of any option exercise. It should simplify administration of the company's option program. The only exception might be those extraordinary situations in which executives are not expected to confront the adverse tax consequences associated with the AMT.

[31]*See* reg. section 1.421-1(h)(2). At this point, the ISO simply becomes a nonincentive stock option.

[32]*See* section 422(d)(1). (''To the extent that the aggregate fair market value of stock with respect to which incentive stock options . . . are exercisable for the 1st time by any individual during any calendar year . . . exceeds $100,000, such options shall be treated as options which are not incentive stock options.'') *See also* reg. section 1.422-4.

[33]The ISO rules require the option holder to pay the exercise price by tendering either cash or company stock. Merely tendering the option in exchange for stock equal to its value will always produce the same result as a nonincentive stock option: immediate ordinary income.

[34]Reg. section 1.421-1(h)(1). (''An option is a statutory option only if, at the time the option is granted, the optionee is an employee of the corporation granting the option, or a related corporation of such corporation.'') *See also* section 422(b).