

How Should Government Tax Incentive Stock Options? The Case for the Alternative Minimum Tax

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On Sunday, Feb. 5, 2006, *The Des Moines Register* ran a lead editorial entitled, “Free those trapped by unfair tax.” The “culprit” the Register cited was the alternative minimum tax and its specific tax treatment of incentive stock options (ISOs).

The story it presented was that of Ron and June Speltz. In 1992, Ron worked for McLeodUSA and elected to exercise an incentive stock option (ISO) offered by the company, buying shares of the stock at well below the current market price. The difference between what the Speltzes paid for the stock and what the stock traded at was \$700,000 – effectively a \$700,000 profit or bonus. According to the editorial, financial advisers recommended that the Speltzes hold the stock for a year so that, when they sold any shares, they would pay a reduced amount of taxes on the profit. The Speltzes held onto all the McLeodUSA stock rather than immediately selling a portion to cover their tax liability. Unfortunately, the stock fell to be worth almost nothing over the next year.

Incentive stock options (unlike other forms of stock options) are not subject to the regular federal income tax at the time they are exercised. They are subject to the federal alternative minimum tax (AMT), however, although the AMT generally taxes them at a lower rate than would the regular federal income tax. Still, under the AMT the \$700,000 is treated as income for the year in which the option is exercised, which made the difference between what they paid for the stock and what the stock was worth at that time subject to some federal tax.

When it came time for the Speltzes to pay their taxes, the stock, even if sold, could not pay this tax bill. “We now have a huge debt to the bank and credit cards because all the money we would normally be living on we were spending on attorneys,” Ron Speltz is quoted as saying in the *Register*. The article reported the Speltzes’ debt as approximately \$250,000 as a result of the tax liability and subsequent actions.

Certainly, the Speltzes fell victim to a sudden downturn in the stock that impoverished them and left them with a substantial tax debt. At the same time, they might have taken action at the time they exercised the ISO to protect themselves. They might have immediately sold a sufficient amount of the stock to cover their tax liability. This would have protected them from going into debt to the Internal Revenue Service.

The federal decision to tax incentive stock options under the alternative minimum tax was developed to curb a very genuine tax loophole that otherwise would enable corporate executives, in particular, to shelter large amounts of revenue from any taxation.

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One rationale for giving incentive stock options to employees is that it creates a larger stake for them in the corporation. Since they own stock, they will have an even greater economic self-interest in seeing the corporation does well, since they only will reap a benefit from the ISO if the stock appreciates in value.

A second rationale for incentive stock options, however, is their tax treatment. Under the federal individual income tax, incentive stock options are not taxed until the stock is sold (and, if it is transferred through an estate or a gift, may never be taxed). With planning, a corporate executive might take advantage of incentive stock options each year, for a number of years, and not pay any federal individual income tax on the actual gain received each year. In essence, this represents a huge tax benefit over receiving a regular bonus. Clearly, this is the sort of tax opportunity that is not available to most American taxpayers and primarily benefits the top 1 percent of all tax filers.

The alternative minimum tax, however, partially corrects this loophole by potentially capturing a portion of the value of the ISO up front, in the year in which the ISO benefit is received. For taxpayers who become subject to the alternative minimum tax, the value of the ISO at the time it is received is taxable. The alternative minimum tax rate, after a substantial flat deduction, is substantially lower (28 percent) than the highest federal individual income tax rate (36 percent). In other words, even if an ISO is taxed within the alternative minimum tax, it generally is taxed at a much lower rate than a traditional bonus or other form of salary benefit.

The Des Moines Register described the provision that targets Incentive Stock Options in the alternative minimum tax as a “quirk,” but it is, in fact, the rationale for the alternative minimum tax in the first place. The alternative minimum tax was designed as a way to limit the benefit of different tax shelters by creating a mechanism where that tax sheltered income is subject to tax. The alternative minimum tax itself is in need of reform – but primarily through indexing the tax to adjust for inflation, incorporating more equitable exemptions that recognize the cost of caring for dependents, and including a broader range of tax preferences/loopholes under its purview (rather than eliminating those, like ISOs, that now exist).

Incentive Stock Option: Description and Example

An incentive stock option is a benefit that a company provides employees that allows them the option to buy stock in the company in the future at the current market price. The employee may choose if, and when, to exercise that option. If the stock appreciates substantially, the employee's option can be worth a great deal. Unlike other forms of stock options, the regular federal income tax does not tax ISOs at the time the stock is purchased, unless it is taxed within the alternative minimum tax.

As an example of an ISO, an employee might be given an option to buy 1,000 shares of company stock anytime in the next five years, at the current market price of \$10 per share. Three years later, the stock might have risen to \$100 per share and the employee takes up the option to purchase 1,000 shares of the stock at \$10 per share. For the \$10,000 investment, the employee now has shares worth \$100,000 – for a \$90,000 benefit or gain.

Tax advisers promote ISOs and indicate they can have significant tax advantages over traditional bonuses. At the same time, most advisers also warn that the policies governing ISOs are complex and that the effects of the alternative minimum tax need to be considered when exercising the option.

On the whole, the provisions regarding ISOs included in the alternative minimum tax help to eliminate what would otherwise be a major tax loophole. Unfortunately, the *Register* article and other news stories about it help to continue a perception – in this instance false – that the tax code has irrational provisions that work to the detriment of people who work hard, struggle to get by, and play by the rules.

The federal income tax system needs to be more conscientious in identifying and eliminating tax provisions that provide loopholes to circumvent taxation by the most well-to-do. If anything, the ISO provisions should be incorporated into the individual federal income tax as well as the alternative minimum tax, rather than removed from the latter.

Addressing the Special Situation of the Speltz Family

Although the United States has a long legal history that “ignorance of the law” does not serve as a defense, there may be reason to provide some very limited relief to individuals like the Speltzes, who received paper ISO profits that disappeared when their stock dramatically declined in value. Any such changes in the federal tax code, however, need to be very tightly drawn to avoid creating additional tax benefits for ISOs.

The article did not specify whether the Speltzes were required to hold their McLeodUSA stock for a specified period of time after exercising the option to purchase it, but employers in some instances do require that ISOs be held for a year after purchase. Retrospectively in such instances, Congress could limit the amount of tax liability incurred as a result of exercising an ISO to the value the stock had at the time the stock was sold. Congress could even extend this provision to individuals who held onto the stock even though they could have sold it. This would eliminate a tax obligation in excess of the value of the stock received and sold through the ISO that the Speltzes face.

In the future, Congress could also require companies providing ISOs to allow people exercising the options to convert an amount of the stock necessary to cover expected AMT liability and could require individuals exercising ISOs to make additional withholding payments to cover the expected AMT liability.

Clearly, the Speltzes and a small number of others like them have fallen victim to economic misfortune by the sudden loss of a large asset – as have people who have had emergency medical expenses, have been victims of theft, or lost their jobs. Yet if the Speltzes had won a \$700,000 lottery prize and used it to purchase McLeodUSA stock that then lost 90 percent of its value, there would likely be little outcry that they should not still be required to pay taxes on the \$700,000 prize they won. The problem here is not the alternative minimum tax and its treatment of ISOs, but the manner in which individuals benefiting from ISOs are advised about the tax impacts and take action at the time of exercising the ISO option to ensure they can cover these tax liabilities. This is not an issue that is unknown by tax advisers – quite the contrary. A simple “Google” search for “incentive stock options” and the AMT produces a wealth of information and advice on addressing this complex issue.

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The Iowa Fiscal Partnership is a joint initiative of the Iowa Policy Project and the Child & Family Policy Center, two nonprofit, nonpartisan Iowa-based organizations that cooperate in analysis of tax policy and budget issues facing Iowans. IFP reports are available on the web at <http://www.iowafiscal.org>.