STROOCK

SPECIAL BULLETIN

ISO-lated No More?

Tax Reform and Incentive Stock Options

December 22, 2017

I. Overview of AMT Changes

The reconciliation of the House and Senate versions of the Tax Cut and Jobs Act,[1] the sweeping Tax Reform Act overhauling the U.S. federal income tax code (the "Tax Reform Act"), has been finalized and signed by the President. One feature of the Tax Reform Act is the change in the thresholds and phase-out for the alternative minimum tax ("AMT").

The AMT is imposed on individuals in an amount by which the tentative minimum tax exceeds the regular income tax for the taxable year. The Tax Reform Act provides that for taxable years beginning in 2017, the tentative minimum tax is the sum of (1) 26 percent of the taxable excess as does not exceed $187,800 ($93,900 in the case of a married individual filing a separate return) and (2) 28 percent of the remaining taxable excess. The breakpoints are indexed for inflation. The taxable excess is so much of the alternative minimum taxable income as exceeds the exemption amount.

Although a thorough discussion of the AMT regime is beyond the scope of this *Stroock Special Bulletin*, the Tax Reform Act temporarily increases both the exemption amount and the phase-out thresholds for the individual AMT. Under the Tax Reform Act, for taxable years beginning after December 31, 2017, and beginning before January 1, 2026, the AMT exemption amount is increased to $109,400 for married taxpayers filing a joint return (half this amount for married taxpayers filing a separate return), indexed for inflation. The phase-out thresholds are increased to $1,000,000 for married taxpayers filing a joint return, and $500,000 for all other taxpayers (other than estates and trusts), indexed for inflation.

II. ISOs

Incentive stock options ("ISOs") are stock options that allow employees to delay the payment of U.S. federal income tax that otherwise would be due upon the exercise of a "regular" or nonqualified stock option until the later sale of the underlying security, provided the individual satisfies certain holding periods and the ISOs meet certain other conditions. In addition, if the shares are sold (other than in a disqualifying disposition, as discussed below), then the difference between the proceeds received upon sale of the shares and the employee's basis (*i.e.*, usually the exercise price and other assorted charges) is a capital gain or loss. There are also no employment taxes owed and no tax withholding on grant, exercise or disposition of shares acquired on the exercise of an ISO. There are several additional requirements to qualify as an ISO. For example, a 10 percent or more shareholder of the issuer can only be granted an ISO that has an exercise price of not less than 110 percent of the fair market value at grant. In

[1] The Tax Cuts and Jobs Act, H.R. 1, as amended.

addition, the "benefit" of ISO treatment is limited to only $100,000 in any given year of exercise.

Further, to receive the favorable tax treatment, the shares acquired upon exercise of the ISO must not be disposed of in a "disqualifying disposition." A "disqualifying disposition" is a disposition of the shares acquired by the exercise of an ISO within two years after the grant of the ISO or within one year after its exercise. In the event of a disqualifying disposition, the employee would recognize income in an amount equal to the excess of the value received on the disqualifying disposition over the exercise price of the shares.

Finally, it is important to note that the employer does not receive a tax deduction on the grant or exercise of an ISO. The employer is only permitted a deduction if (and to the extent that) the employee has compensatory income arising out of a disqualifying disposition.

III. Planning Considerations

One disadvantage of ISOs is that the spread between the exercise price and the value on exercise is an add back to income for purposes of calculating the AMT. In considering ISOs, compensation planners have had to contend with some of the features associated not only with the positive economics associated with ISOs, but also the limitations. This has resulted in a limit as to the use and benefit of ISOs. As a result of the increase in AMT limits, ISOs may be more attractive to employees, and companies may wish to reconsider the use of ISOs as part of their compensation program. Where and how this may result in trends more broadly, only the future will know.

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