

=DJ GETTING PERSONAL: Tax Planning Is Critical With ISOs

By Tara Siegel Bernard
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NEW YORK (Dow Jones)--When paying tax, it doesn't get much worse than racking up a tax bill on profits you never actually get.

But for holders of incentive stock options, that's a potential headache of the alternative minimum tax. The reasons are complicated, but a quirk in the AMT - the parallel tax system conceived to prevent overuse of tax deductions, but which has instead trapped millions of middle-class taxpayers - could create a huge tax bill on paper gains that never materialized.

The most sage advice for ISO holders is to see a tax specialist, because there are a variety of ISO strategies which can limit the tax fallout. For example, by being precise about how many options you exercise and when in the tax year you do it, the tax liability can be reduced.

About one million individuals hold incentive stock options, estimates the National Center for Employee Ownership. Holders are only subject to a 15% capital gains tax if the underlying stock is sold (as long as the stock is not sold within a year of option exercise or within two years of the option grant date).

But there's another colossal caveat. For alternative minimum tax purposes, the spread between the option price and the stock's fair market value at the time of exercise is added to your income - even if you haven't sold the stock. That could push some taxpayers into AMT territory that might have dodged it otherwise. And back to the worst-case scenario: Should the stock dive, individuals could owe a potentially enormous tax bill on phantom gains that simply vaporized.

First, a quick AMT recap. This parallel tax system was installed in 1969 to ensure the wealthiest Americans were paying their fair share of taxes by reducing the amount of deductions they can take. However, it was never indexed for inflation and has increasingly trapped more middle-class taxpayers.

To determine AMT tax liability, two calculations are necessary: one under the traditional tax system and another under the AMT system, where various deductions - such as state and local income taxes, property taxes, miscellaneous deductions and personal exemptions and others - are added back (ISO spread income is also added). You must pay the greater of the two. Though the AMT rate is either 26% or 28% - a lower rate than the highest marginal tax bracket of 35% - it's applied to a wider base of income, making that tax bill more costly.

That's why the resounding lesson is thoughtful planning because a clever strategy can make the best of this complicated tax scenario.

"When you exercise ISOs it may put you in AMT and one of the strategies is to look at your income for the year and maybe you exercise just enough to stay out of AMT," says Bernie Kent, personal finance partner with PricewaterhouseCoopers Private Company Services. He said those in the \$150,000 to \$382,000 income range

(for married couples filing jointly in 2005) are more susceptible to AMT. (Ironically, the likelihood of AMT starts dropping once ordinary income hits roughly \$400,000.)

Several advisors also recommend that individuals who've decided to exercise their ISOs do so as early in the year as possible, preferably January.

"Then, you can monitor the stock price throughout the year," says Beth Maxwell, a managing director with Wealth and Tax Advisory Services Inc., a unit of HSBC Holdings. "If the stock price increases, the individual can hold on to their shares, meet the required holding period and lock in long-term capital gains rates. Alternatively, if the stock price falls, then you have the opportunity to fold up the transaction, sell the shares and alleviate" the AMT trigger.

That's because if you exercise the ISOs and sell the shares in the same year, it disqualifies the stock from receiving favorable tax treatment and no longer triggers AMT. As such, investors don't have to pay the AMT on the spread between the exercise price and the fair market value at the time of exercise. Instead, investors recognize ordinary income on the difference between their exercise price and the sale price.

Take a person that exercises the ISO at \$5 while the stock's fair market value was \$20. While holding the shares, they drop to \$6. If the person sells the shares in the same year, they'll simply recognize ordinary income on the gain of \$1 a share.

If they held the shares and sold at \$6 in the following year, for AMT purposes, they will have to report the phantom income - \$15 a share - on their tax return for year one. The sale of the stock is accounted for in year two: it will create a regular income-tax gain of \$1 a share and an AMT capital loss of \$14 a share. This loss may generate a tax benefit, or credit, in year two but there's a catch: you need to be no longer subject to AMT to recognize it.

Sound complicated? It is.

"This amounts to an interest-free loan to the government in which the government may never pay back," says Jay Cena, co-founder of ReformAMT, (www.reformamt.org), a Silicon Valley-based activist organization aimed at reforming the AMT as it relates to ISOs. Many members ran into big problems - from bankruptcy to being forced to sell their homes - after the dot-com bust. "It's pretty restrictive in terms of the criteria you need to meet to recoup the credit."

While Congress has yet to reform the AMT overall - though both proposals to revamp the tax code announced last month by the Federal Tax Reform advisory panel recommended eliminating it altogether - Rep. Sam Johnson, R-Texas, along with a bipartisan group of co-sponsors, introduced legislation last July to rectify AMT rules as they relate to ISOs. But until anything is actually passed - AMT is estimated to impact 4 million people in 2005 and 21 million next year - ISO holders must exercise caution.

"There are so many variables and the minute we try to answer and make a generalized statement, you're opening up a Pandora's Box," says William O. Wright, financial planner and president of Guidance Financial Consultants Inc. in Wichita, Kan. "The smartest exercise strategy is to go to a tax

professional."

(Tara Siegel Bernard is one of four Getting Personal columnists who write about personal-finance issues ranging from new tax proposals to education-funding strategies to estate planning.)

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