



**To:** Whom it may concern

**From:** Donovan Thomas Billings, CPA on behalf of DTB Tax

**Date:** November 18, 2006

**Re:** Alternative Minimum Tax (AMT) – Exercise of ISO Options

Generally, when a given employee exercises an incentive stock option (ISO), he or she will have no tax liability under the “regular” federal tax system; however, the spread between the exercise price and fair market value (FMV) of the stock at the time of exercise is usually considered to be an “item of adjustment” under the federal Alternative Minimum Tax (AMT). This “item of adjustment” increases the personal federal tax obligation of the given employee in the year of exercise and, in most general conversation, should be considered “AMT Income” as this is more easily understood by the general population.

**NOTE:** If the given employee disposes of stock within the same taxable year in which he or she exercises ISO options, the spread between the exercise price and FMV price is NOT subject to the Alternative Minimum Tax and is instead considered a “disqualified disposition.” This “disqualified disposition” is considered compensation to the employee from the company and the income is taxed at regular tax rates.

Once the given employee pays tax under the Alternative Minimum Tax as a result of exercised ISO Option, the tax paid could offset taxes due when he or she sells the stock in a subsequent year. The tax paid under the Alternative Minimum Tax becomes a credit to be applied against his or her regular tax in a later year. The exercise of an ISO is considered a timing issue because a given employee is taxed on their stock under the “regular” federal tax system when they sell it; that is, at a specific time. Because ISOs involve a timing issue, he or she can apply the AMT credit against a later stock sale. The amount of the credit depends upon whether the credit arose from such a “timing issue.” A given AMT credit has two components:

1. The amount of the credit; and
2. Whether the credit is available to use in the current year

**NOTE:** The AMT credit cannot be applied against future AMT liability. The credit ONLY applies when “regular” federal income tax exceeds AMT liability, and then only

to the extent of the difference between the “regular” federal income tax and the AMT liability.

The rules involving dual basis in stock, the use of AMT credits, and AMT capital loss carryforwards are relatively complex and require specific tax knowledge along with proper tax software. Note that many consumer-based tax software programs do not adequately compute these values. Use of an experienced tax professional (a CPA, tax attorney, or EA) is highly recommended when contemplating the exercise of, sale of, or conversion of, any type of stock option. Lack of proper tax planning can result in significant tax liabilities.

For more information, please contact Donovan Billings, CPA at:

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