

Tax Considerations for Incentive Stock Options: AMT Implications and Planning Framework

By: Taimoor J. Choudhry
May 05, 2026



Incentive stock options (“ISOs”) are a tax-advantaged form of equity compensation. If properly structured and held for the requisite periods, gain realized upon sale of shares acquired through an ISO may be treated as long-term capital gain (generally taxed at rates up to 20%) rather than ordinary compensation income (taxed at rates up to 37% federally). Moreover, unlike non-qualified stock options (“NSOs”), the holder of an ISO upon exercise generally does not recognize income on the difference between the fair market value at exercise and the exercise price. By contrast, that discount is treated as ordinary compensation income in the case of non-qualified stock options. ISOs therefore allow the holder to acquire shares without immediate tax liability and defer taxation of gain until disposition.

This favorable treatment, however, is subject to the Alternative Minimum Tax (“AMT”) regime. For AMT purposes, the difference between the fair market value of the shares and the exercise price is included in income upon exercise of an ISO. Thus, the central tradeoff inherent in ISOs is between the potential for tax-efficient capital gain treatment and the risk that AMT accelerates taxation to the exercise date.

This article provides an overview of the tax treatment of ISOs under both the regular tax system and the AMT regime, with a focus on planning strategies to manage resulting AMT exposure.

I. Overview of ISO Tax Treatment

Because of their favorable tax treatment, ISOs are subject to a number of qualification requirements that must be satisfied in order to preserve their benefits. Most notably, ISOs may be granted only to employees (and not independent contractors) and must be issued pursuant to a written plan. In addition, ISOs are subject to specific structural limitations, including:

- **Exercise price requirement:** must be at least FMV at grant (otherwise you lose ISO status)
- **\$100,000 annual vesting cap:** only \$100,000 (measured at grant) can vest as ISOs per year; excess becomes NSOs
- **Post-termination exercise window:** generally 90 days to exercise and retain ISO status
- **Non-transferability:** generally cannot be transferred

Importantly, to obtain the full tax benefit of ISOs, the underlying shares must be held for a minimum period—generally at least two years from the date of grant and one year from the date of exercise. A sale prior to satisfying these holding periods (a “disqualifying disposition”) does not prohibit the transaction but results in a loss of favorable capital gain treatment, with a portion of the gain instead taxed as ordinary income.

II. ISO-AMT Interaction

As discussed, no regular income tax is imposed upon the exercise of an ISO. For purposes of the AMT, however, the discount—the difference between the fair market value of the shares at exercise and the exercise price—is included in Alternative Minimum Taxable Income (“AMTI”). This inclusion applies even though the shares have not been sold and no cash has been received by the holder.

As a result, the holder may be required to pay tax on unrealized economic gain at the time of exercise under the AMT regime. This creates a potential cash flow mismatch, where tax is owed without corresponding proceeds from a sale of the underlying shares to help pay for the tax. This risk is particularly acute in the case of private or private and closely held companies, where liquidity is limited or unavailable, and in situations involving a significant discount at exercise, which can result in substantial AMT exposure.

To mitigate the impact of AMT, any AMT paid as a result of ISO exercise generally gives rise to an AMT tax credit. This credit may be used in future years to offset regular tax liability to the extent that such liability exceeds the taxpayer’s AMT for that year. The credit carries forward indefinitely; however, it is recoverable in future years to the extent regular tax exceeds AMT. As a result, utilization of the credit may be delayed for multiple years, particularly if the taxpayer continues to be subject to AMT. In addition, the credit does not protect against declines in the value of the underlying stock, meaning that tax may have been paid on unrealized gains that are never ultimately realized.

Illustrative Example 1:

Assume that Company A grants Employee A an incentive stock option covering 10,000 shares. The exercise price of the option is \$2 per share, and at the time Employee A exercises the option, the fair market value of the underlying shares is \$35 per share. Employee A exercises the option in full during the year but does not sell any of the shares in that year. For purposes of this example, it is assumed that the option qualifies as an ISO under applicable requirements.

In this scenario, Employee A acquires shares at a significant discount to their fair market value. The difference between the fair market value at exercise and the exercise price—referred to herein as the discount—is \$33 per share. On an aggregate basis, this results in a total discount of \$330,000.

Below are the tax consequences in the year of exercise based on regular tax treatment and AMT treatment:

Item	Regular Tax Treatment	AMT Treatment
Income recognized at exercise	\$0	\$330,000 (discount included in AMTI)
Tax liability at exercise	None	Potential AMT liability based on \$330,000 inclusion
Cash received	None	None

Assuming applicable AMT rates, the inclusion of \$330,000 in AMTI could result in a federal tax liability in the range of approximately \$85,000 to \$92,000, notwithstanding that no shares have been sold, and no proceeds have been received.

III. Decision Framework – ISO Exercise and AMT Exposure

The decision to exercise ISOs—and whether to hold or sell the underlying shares—requires balancing the potential for favorable capital gain treatment against the risk of AMT exposure.

These considerations are particularly important where employment has been terminated, as ISOs are generally subject to a limited post-termination exercise window (typically 90 days) to retain their favorable tax status, which can force an accelerated exercise decision without a corresponding liquidity event. The following considerations provide a practical framework for evaluating that decision.

A. Question 1: Will the shares be sold in the same tax year as exercise?

If the shares are sold in the same year as exercise, the transaction will constitute a disqualifying disposition. In that case, the discount at exercise is treated as ordinary income, and no AMT exposure arises. While this approach eliminates the risk of AMT, it also forfeits the potential for long-term capital gain treatment. If the shares are not sold in the same year, the holder must consider the resulting AMT implications. Below is an example to illustrate this point.

Illustrative Example 2:

Assume the same facts as reflected in Illustrative Example 1. Employee A holds an incentive stock option covering 10,000 shares with an exercise price of \$2 per share. At the time of exercise, the fair market value of the underlying shares is \$35 per share, resulting in a discount of \$33 per share, or \$330,000 in the aggregate. Assume further that, following exercise, Employee A ultimately sells the shares at \$50 per share.

Scenario 1: Employee A exercises the ISOs and sells all shares in the same year.

Item	Amount / Treatment
Shares	10,000
Exercise Price	\$2 per share
FMV at Exercise	\$35 per share
Sale Price	\$50 per share
Discount at Exercise	\$330,000 (taxed as ordinary income)
Additional Gain	\$150,000 (taxed as short-term capital gain)
Ordinary Income Tax	$\$330,000 \times 37\% = \$122,100$
Capital Gain Tax	$\$150,000 \times 37\% = \$55,500$
Total Federal Tax	~ \$177,600
AMT Impact	None
Liquidity	Yes (shares sold)

As illustrated above, because Employee A sells the shares in the same year as exercise, the transaction constitutes a disqualifying disposition. As a result, the \$330,000 discount at exercise is taxed as ordinary income, and the additional \$150,000 of gain (i.e., the excess of the \$50 sale price over the \$35 fair market value at exercise, multiplied by 10,000 shares) is treated as short-term capital gain. Although this approach results in a higher overall tax burden due to ordinary income rates, it eliminates any AMT exposure and provides immediate liquidity to satisfy the resulting tax liability. Had Employee A instead held the shares, the \$330,000 discount would have been included in AMTI, potentially resulting in a federal AMT liability in the range of approximately \$85,000 to \$92,000, notwithstanding that no shares were sold.

Scenario 2: Employee A exercises the ISOs and holds the shares through the required holding periods before selling.

Item	Amount / Treatment
Shares	10,000

Item	Amount / Treatment
Exercise Price	\$2 per share
FMV at Exercise	\$35 per share
Sale Price	\$50 per share
Total Gain (upon sale)	\$480,000 (taxed as long-term capital gain)
Ordinary Income Tax	0
Capital Gain Tax	$\$480,000 \times 20\% = \$96,000$
Total Federal Tax	\$96,000
AMT Impact	\$330,000 included in AMTI (= \$85,000 ~ \$92,000)
Total Tax (Federal and AMT)	\$181,000 ~ \$188,000
Liquidity	None at exercise (tax due before sale)

As illustrated above, because Employee A holds the shares through the applicable holding periods, the entire \$480,000 of gain is eligible for long-term capital gain treatment, resulting in a significantly lower tax rate on the ultimate disposition. However, this benefit comes with an important tradeoff. Upon exercise, the \$330,000 discount is included in AMTI, potentially resulting in a federal AMT liability in the range of approximately \$85,000 to \$92,000, even though no shares have been sold and no proceeds have been received. The holder must therefore satisfy this tax liability in advance of any liquidity event.

Upon a later sale, the holder will also incur long-term capital gains tax of approximately \$96,000. Although the combined amount of AMT paid at exercise and capital gains tax paid at sale may initially exceed the total tax payable in a same-year sale scenario, the AMT paid generally gives rise to a minimum tax credit that may be used to offset future regular tax liability. Accordingly, the AMT is more appropriately viewed as a timing difference rather than a permanent additional tax cost, albeit one that introduces liquidity and cash flow considerations.

A disqualifying disposition—i.e., a sale of shares prior to satisfying the applicable holding periods—may be used deliberately to manage AMT exposure. By triggering ordinary income treatment, such a sale eliminates or reduces AMT liability associated with the exercise. However, this approach comes at the cost of losing the preferential capital gain treatment that ISOs are designed to provide.

B. Question 2: Is the spread (i.e., the difference between fair market value and exercise price) significant?

The magnitude of the spread at exercise is the primary driver of AMT exposure. Where the spread is relatively modest, the resulting AMT liability may be limited and more manageable. In such cases, the approach described in **Illustrative Example 2—Scenario 2** (i.e., exercising and holding the shares through the applicable holding periods)—may be preferable, as the holder can obtain the benefit of long-term capital gain treatment without incurring a significant upfront AMT burden. By contrast, a significant spread, as reflected in the example above, can result in substantial inclusion in AMTI and corresponding tax liability, increasing the risk associated with holding the shares and potentially making a same-year sale or other mitigating strategy more appropriate.

C. Question 3: Is there sufficient liquidity to satisfy potential AMT liability?

Because AMT may be triggered without a corresponding liquidity event, the holder must assess whether sufficient cash or other resources are available to pay the resulting tax. If adequate liquidity exists, the holder may choose to retain the shares in pursuit of long-term capital gain treatment. If liquidity is constrained, the holder should consider alternative strategies to mitigate AMT exposure, including exercising only a portion of the options, selling shares in the same year as exercise, or staging exercises over multiple tax years.

IV. Conclusion

ISOs offer significant tax advantages by enabling the conversion of compensation income into long-term capital gain; however, they also introduce timing-based tax risk through the AMT regime. As discussed above, the decision to exercise ISOs requires balancing the potential benefit of favorable capital gain treatment against the risk of immediate AMT exposure and the associated liquidity constraints.

In particular, the timing of exercise is a critical consideration. Exercising earlier, when the fair market value of the underlying shares is lower, reduces the discount at exercise and, therefore, the resulting AMT exposure. Holders should also be mindful that AMT is based on the fair market value of the shares at the time of exercise and does not take into account subsequent changes in value. As a result, exercising at higher valuations increases the risk that tax will be paid on unrealized gains that may not ultimately be realized.

Liquidity planning is equally important, as AMT may be triggered without a corresponding liquidity event. Holders should avoid exercising a significant number of options without sufficient cash reserves or a reasonable expectation of near-term liquidity, as this may result in tax liability that cannot be readily satisfied. In addition, staged exercises may be used to spread AMT exposure across multiple tax years, thereby reducing the likelihood of a large, single-year tax burden.

Disposition strategy also plays a key role. As discussed above, a disqualifying disposition may be used as a tool to manage AMT exposure by converting the discount at exercise into ordinary income and eliminating or reducing AMT liability, albeit at the expense of long-term capital gain treatment. Accordingly, any ISO exercise strategy should be evaluated in light of both the expected tax outcome and the holder's ability to manage the timing and liquidity implications associated with AMT.

For more information, please contact **Taimoor Choudhry**.