Startup America: How To Make Life Better For Startups (Installment 3)

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This is part of a series, directed at those individuals involved in President Obama's Startup America initiative. The task is this–write about what the President and Congress can do to make life better for startup companies, by making the law simpler, less complex, easier to understand, and better for startups.

Today's topic–the alternative minimum tax on incentive stock options (ISOs).

If you are not aware, ISOs are supposed to be a good deal. If you receive an ISO, you don't have tax on receipt, and you don't have ordinary income on the exercise of the ISO even if the fair market value of the underlying stock exceeds the exercise price. In addition, if you hold the stock for at least 1 year from exercise and at least 2 years from the date you received the option, your gain on sale will be capital gain, not ordinary income.

This sounds great. The only hitch is this–the spread on exercise is an alternative minimum tax adjustment. So, despite the fact that there is no "ordinary income" on exercise, the exercise will very likely trigger AMT, and potentially a substantial amount of AMT. The additional problem is that the AMT is not easily calculable. It requires optionees to consult with their tax advisors, and very frequently optionees are caught off guard when it is time to file tax returns in the year following exercise.

Many people got in quite a bit of trouble with ISOs during the dot com boom when they exercised ISOs, the market crashed, and then they discovered that they owed more in AMT than their stock was worth.

The AMT problems associated with ISOs make them problematic, and usually not very attractive relative to the transparency and ease of understanding nonqualified stock options.

ISOs are a great idea, the trouble is that the AMT has taken away the originally contemplated value of ISOs.

What should Startup America do? Repeal the provisions of the Internal Revenue Code that make the spread on the exercise of an ISO an AMT adjustment.