EXECUTIVES WITH EQUITY COMPENSATION

The ISO Trap: How Incentive Stock Options Trigger AMT — and How to Plan Around It

Exercise and hold your incentive stock options and you may owe a large tax bill on income you never received in cash. Understanding the AMT mechanics before you exercise is the difference between a favorable long-term result and an April surprise you have to borrow to pay.

Incentive stock options are the most tax-favored form of equity compensation in the code — and the most dangerous to exercise without a plan. Their entire appeal rests on a hold: exercise, wait, and a qualifying sale is taxed at long-term capital gains rates rather than as ordinary income. But the very act of exercising and holding, the thing that unlocks the favorable treatment, is what can generate a tax bill on paper gains you have not sold.

That bill comes from the alternative minimum tax, and for 2026 the AMT rules have tightened in a way that makes ISO exercises more likely to trigger it than they have been in years. Here is exactly how the trap works, what changed, and how the planning is done.

Why an ISO exercise creates phantom income

When you exercise an ISO and hold the shares, nothing is taxable under the *regular* tax system — there is no ordinary income and no withholding. That is the headline benefit. But the AMT runs as a parallel system with its own rules, and under those rules the **bargain element** — the difference between the fair market value at exercise and your strike price — is treated as income in the year you exercise, even though you sold nothing and received no cash.

> THE MECHANISM IN ONE LINE
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> Exercise 10,000 ISOs with a $5 strike when the stock is worth $50, and you have created a **$450,000 bargain element** — income that is invisible to the regular tax system but fully counted under the AMT. You now owe tax on value you are still holding, not spending.

The cruelty of the trap is its timing. If you exercise early in the year and the stock falls before you sell, you can owe AMT on a paper gain that no longer exists — the classic story of employees who exercised at the top and were left with a tax bill larger than the stock's remaining value. The AMT is calculated on the value at exercise, not on what you eventually receive.

How the AMT actually gets computed

The AMT is not an extra tax bolted onto your regular bill; it is a shadow calculation. You compute your tax two ways — once under the regular rules, once under the AMT rules with the bargain element added back — and pay whichever is higher. The AMT gives you an exemption that shields a slug of income, then taxes the rest at a 26% or 28% rate.

> 2026 AMT FIGURES (REV. PROC. 2025-32)
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> The 2026 AMT exemption is **$140,200** for married couples filing jointly and **$90,100** for single filers. The 28% AMT rate applies to AMTI above **$244,500** of excess income. Critically, the exemption itself phases out — and under the One Big Beautiful Bill Act, that phase-out now begins at just **$1,000,000** of AMTI (married filing jointly) or **$500,000** (single), and disappears at **50 cents per dollar** — twice the old rate.

That last change matters enormously for equity-comp executives. Before 2026, the exemption phased out gradually and started much higher. Now the exemption vanishes faster and at a lower income level, which means a large ISO exercise stacked on an already-high salary can lose the exemption entirely — enlarging the AMT hit exactly when the bargain element is largest. The window in which AMT bites has been compressed, and high earners with concentrated equity sit right inside it.

The credit that softens the blow — over time

The AMT you pay on an ISO exercise is not necessarily lost. It generally becomes a **minimum tax credit** you can carry forward and use in future years when your regular tax exceeds your tentative AMT. In the year you finally sell the shares in a qualifying disposition, the regular-tax gain is often large enough to let you recover the credit.

But "over time" is the operative phrase. The credit can take years to fully recover, it is a timing benefit rather than a refund, and in the meantime you have parted with real cash. Treating the

AMT as "money you get back" without modeling *when* is how executives end up cash-strapped by a paper event.

The planning moves that keep an exercise favorable

WHERE THE STRATEGY LIVES

The goal is almost never "never trigger AMT." It is to trigger it deliberately, in the right amount, in the right year — capturing the long-term capital gains treatment without an outsized or mistimed bill.

Exercise up to your AMT "crossover" point

There is usually a quantity of ISOs you can exercise each year before the AMT exceeds your regular tax. Exercising up to — but not far past — that crossover captures shares into the long-term holding clock while keeping the AMT hit small or zero. This is the single most useful ISO planning lever, and it requires running the two-system calculation before you act.

Spread exercises across multiple years

Rather than exercising a large tranche at once, staging exercises across calendar years spreads the bargain element over several AMT exemptions and lower income years — often dramatically reducing the total tax versus a single large exercise.

Exercise early in the year, decide late

Exercising early in the year starts the holding-period clock while preserving an escape hatch: if the stock drops sharply, a same-year *disqualifying* sale before year-end can unwind the AMT exposure (the bargain element becomes ordinary income instead, but you avoid AMT on a gain that vanished). This "exercise early, evaluate at year-end" discipline is a core risk control.

Model the California layer

California has its own AMT system that runs parallel to the federal one, so an ISO exercise can trigger state AMT as well. The combined federal-and-California exposure — and California's separate credit — has to be modeled together, not as an afterthought.

Coordinate with the rest of your return

The right ISO exercise size depends on everything else in your year: salary, bonus, RSU vesting, a spouse's income, other capital gains. An exercise that is fine in a low-income year is a mistake stacked on a bonus year. The exercise decision cannot be made in isolation from the full projection.

> A WORD ON CASH
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> An ISO exercise costs cash twice: the strike price to acquire the shares, and potentially the AMT to hold them. Before exercising, the plan has to answer where both come from — and whether the shares are liquid enough to sell some to fund the rest without blowing up the qualifying-disposition treatment on the shares you keep.

How I work with executives on ISO strategy

ISO planning is a modeling exercise done *before* the exercise, not a cleanup after. I run the two-system federal and California calculation to find your crossover point, size the exercise to your full-year income picture, build a multi-year staging plan where it reduces the total tax, and map the minimum-tax-credit recovery so you know when the cash comes back. The aim is to capture the long-term capital gains treatment ISOs are designed to deliver — without letting a paper event become a cash crisis.

If you are holding ISOs and weighing an exercise, the worst version of this is discovering the AMT bill in April. The best version is a deliberate, modeled decision made with the numbers in front of you.

This article is educational and reflects federal and California rules for the 2026 tax year, including the AMT exemption amounts ($140,200 MFJ / $90,100 single), the $244,500 excess-AMTI 28% threshold, and the OBBBA phase-out thresholds ($1,000,000 MFJ / $500,000 single) at a 50% rate, all per Rev. Proc. 2025-32 and OBBBA §70107. Figures in examples are illustrative. Tax outcomes depend on your specific facts; nothing here is tax advice for your situation. Please consult a qualified CPA before exercising options.

Natalie C. Papagni, CPA

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Tax, Planning & Advisory Services | La Jolla, California

4275 Executive Square, Suite 200, La Jolla, CA 92037

(858) 754-8277 | service@lajollataxcpa.com | lajollataxcpa.com