Jackson Walker

Income Tax Changes Warrant Consideration When Awarding Equity Incentives

Tax law is an interrelated web of complex rules, and changes in one rule can impact compensation strategies for management and executives even if the change is to individual income tax calculation rules. Executives should consult with their tax advisors regarding the best strategy for their equity compensation awards and personal income taxes. Companies should consider whether their equity compensation plans are structured to provide management with the most tax efficient incentives to achieve the company's goals.

The increase of the state and local tax ("SALT") deduction may impact the imposition of the alternative minimum tax on executives when, beginning in 2026, the SALT deduction may lower taxable income, but the same deduction increases income subject to the alternative minimum tax, making the exercise of an Incentive Stock Option more likely to trigger alternative minimum tax for the individual. When an Incentive Stock Option is exercised, and the stock is held and not sold, it generates an addition to the income subject to the alternative minimum tax for the individual. The SALT deduction phases out based upon income, so it may not be a factor for some employees but may impact others. So, an individual who has a significant income inclusion, for example, from an RSU vesting or non-qualified stock option exercise, an early Incentive Stock Option sale, or a cash bonus or other taxable income—may see their SALT deduction phase out to zero from the increased income from such actions.

When Restricted Stock Units vest or Nonqualified Stock Options are exercised, the additional compensation from such awards will cause some deductions, such as the SALT to phase out or be eliminated. If an individual has a significant SALT deduction that is not phased out and exercised an Incentive Stock Option in the same tax year, the potential impact of the Alternative Minimum Tax needs to be considered.

If your company's award recipients are concerned about incurring alternative minimum tax, you may want to consider awards that do not generate amounts included in the alternative minimum tax calculation and provide the company with a benefit, such as Restricted Stock, Restricted Stock Units, and Nonqualified Stock Options. The equity award recipients may want to consider seeking income tax advice regarding whether to exercise certain awards in 2025 prior to the new OBBBA provisions becoming effective.

Companies with equity incentive plans should consider which type of award to issue to recruit and retain management and executives. Compensation Committees should consider the types of awards to issue to be competitive for talent and to compensate persons in a manner that is favorable to the individual and to the Company.

While the OBBBA expanded the eligibility for treatment as Qualified Small Business Stock, those provisions are beyond the scope of this alert.

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