Year End Disqualifying Dispositions

What is one to do if, after exercising an incentive stock option, the stock's price plummets? Options exercised at 55 cents per share, when the fair market value is $35, generate $34.45 per share of "preference income.". The stock crashes to 50 cents and you are laid off. You are left with a huge AMT bill and a valueless stock and there might even be an underpayment penalty if you did not properly manage your estimated tax payments during the year!

A sale prior to year's end eliminates the AMT preference income from the earlier exercise. A "disqualifying disposition" - that is, a sale within two years of grant or within one year from exercise - usually causes the recognition of ordinary income equal to the amount of preference income. This ordinary tax is usually more than the AMT because the AMT liability cannot exceed 28% of the preference income whereas the ordinary tax could be as high as 39.6% of the preference income. For this reason, you generally pay more tax with a disqualifying dispositions.

There is a special rule to cover situations where the stock price falls after exercise. If the stock price at the time of a disqualifying disposition is less than the fair market value at the time of exercise, the ordinary income recognized is measured as the difference between the exercise cost and the disposition price, rather than the difference between the exercise cost and the fair market value at the time of exercise.

In extreme cases, where the sale price is less than the cost of the option, the ordinary income is zero and the difference betweeen the sale price and the option price is treated as a short term capital loss. Thus, if you sell under the conditions described above, there will be no AMT preference income, no ordinary income and a short term loss of 5 cents a share.

Your decision should also weigh future tax benefits. The exercise of ISOs provides a tax credit which can lower your tax liability in future years. With proper planning before exercise, you will get all of the AMT back. A disqualifying disposition at a price below the exercise price delays tax but may not, in the long run, save any tax.

Your decision should consider more than the tax impacts. Do you need cash? Do you risk further losses by not selling? Could you buy into this stock?

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My bottom line is to look before you leap. The sale of ISO stock cannot be reversed and the financial consequences of a mistake either way could be substantial. It's something to consider!

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