Disqualifying Disposition of ISO

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Incentive Stock Options (ISOs) are complex. Executives with ISO should seek the advice of a tax professional during all aspects of these transactions in order to help maximize their tax benefits and minimize unfavorable tax consequences.

Generally, an executive does not recognize any income for regular tax purposes on either the grant or the exercise of an ISO. Income would be recognized when the stock is ultimately sold. However, how this income is reported on your tax return depends on whether the sale is a **"qualfying or disqualifying disposition"**.

If an executive sells their stock before they meet the holding period requirements for a qualifying disposition, they may face some unexpected and unfavorable tax consequences.

For example, Ted exercised his ISO to purchase 2,000 shares on January 14, 2006 for $50 when the stock was trading at $80 per share. Ted thought that the price was going to fall, so he sold his stock on September 21, 2006 for $100 per share, realizing a $100,000 gain. Since Ted did not hold onto his stock for at least 1 year after he exercised his option, the IRS refers to this as a **disqualifying disposition**.

Since this is a disqualifying disposition, Ted must recognize $60,000 of ordinary income (the difference between the exercise price and the FMV of stock on the exercise date, reported as compensation) and a $40,000 short-term capital gain (FMV at sale greater than the FMV at exercise date) for regular tax purposes. Luckily Ted will not have an AMT adjustment since the exercise of the ISO and sale of the shares occurred in the same year.

This is just one example of how a subsequent sale of ISO can be considered a disqualifying disposition. Please consult your tax advisor if you have ISOs.

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