Warning! Wash Sale Rule

Due to the increased practice of issuing incentive stock options (ISOs) to company employees, this rule and the attendant warning may affect more individuals today than in previous years. If applicable to your clients, please heed its implications.

Qualified ISOs give an employee the opportunity to buy the stock of his employing company at rates less than the current market price. If exercised, the employee is subject to tax on the "bargain element" which is the difference between the market price of the stock at the time of exercise and the strike price stated on the option.

If the stock purchased with the option is held for more than one year after the exercise date and more than two years after the option was granted, the taxpayer will be eligible for long-term capital gains treatment when the stock is later sold. Thus, the profit would be taxed at a rate of only 20%.

However, if the stock is sold in a later year, the taxpayer is subject to Alternative Minimum Tax (AMT) in the year of exercise. The bargain element will be considered a tax preference item, subjecting the taxpayer to a maximum AMT rate of 28%.

As this tax would be due by April 15th in the year following the exercise, a taxpayer might elect to sell his stock to either raise the funds required to pay the liability or to avoid the AMT hit altogether. By selling in the same year of exercise, the AMT issue disappears but the taxpayer is now left to declare everything as ordinary income.

The recent decline in the stock market may falsely encourage a taxpayer to sell the stock just before year-end, thereby locking in losses rather than gains. But, because the taxpayer believes in the prospects of the company and expects the stock to rebound, he may choose to buy back the shares on the open market.

Unfortunately, if the repurchase is done within less than 30 days, the transaction will be considered a *wash sale* and will be disallowed. The entire paper profit would now have to be reported as income in the year of exercise. But, sadly, the reduced sales proceeds received as a result of the depressed market conditions will most likely not even be sufficient to pay the ensuing tax debt.

Recommendations:

1. If clients choose to sell the shares received upon exercise of an option, they <u>must</u> wait to repurchase these shares for 31 days.

2. If a client has erroneously sold and repurchased shares earlier this year and have already violated the Wash Sale Rule, there is little you can do at this late date un-do the problem. Kaye Thomas, a Chicago tax attorney and author of a book on stock option planning entitled "Consider Your Options", suggests that individuals may want to sell the re-purchased shares before year-end. "Although this will not erase the tax bill, it might make you appear to be a "more sympathetic taxpayer if the IRS ever audits you."

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Opinions and recommendations stated herein are limited to those issues discussed above. This opinion does not consider or provide a conclusion with respect to any additional issues that may exist.

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