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info sheet Handling stock options in a down market

Over the past decade, stock options became an increasingly common form of employee compensation. With a stock option, an employee is granted the right to buy shares of stock in his or her company at a particular price – known as the "grant," "exercise," or "strike" price. During the bull market of the 1990s, when many stocks soared, stock options became a very desirable form of compensation. People whose companies didn't issue options envied employees of firms that did.

In a bear market, however, managing options becomes more complicated. Exercising stock options can bring some unexpected tax consequences. If your stock subsequently declines in value, you'll have to make some decisions about the best way to handle those taxes.

Following are examples of scenarios in which you may find yourself. This information is provided only to help you educate yourself and prepare for the decisions you may face. Because these issues are so complex, you won't want to take any action until you've drawn on the expertise of professional advisers – including your investment professional, accountant, or attorney.

Scenario 1:

You have stock options you haven't exercised yet, and the stock has declined below your exercise price.

Seeing the value of your company's stock sink below the price at which you can exercise your options is very disappointing. But you shouldn't give up on your options. Keep track of the options' expiration date and the daily price of your company's stock. If the stock's price rises above your exercise price, you may want to exercise the options. But if the stock remains "underwater" — that is, below your exercise price — all you can do is let the options expire without taking any action.

Not in your favor

When options are "underwater"

Exercise price	$25/share
Stock's current market price	$5/share
Cost to exercise option for 1,000 shares	$25,000
Market value of 1,000 shares	$5,000

Letting options expire is your only course of action

Scenario 2:

You exercised nonqualified stock options (NSO) and subsequently sold shares at a price below the market value they had when you exercised the option.

In this situation, there are three key facts to bear in mind:

- The difference — or "spread" — between the exercise price of your options and the market value of the stock on the date you exercised the options will be taxed as ordinary income for you.
- If you sell the shares at a price below the market value they had on the date you exercised your options, you will incur a capital loss that can be used to offset taxes you may incur on gains realized from the sale of other assets during the year.

- Your cost basis in your optioned shares will be their market value on the date you exercised your option — not the exercise price you used to purchase the shares.

Exercised NSOs create ordinary income

When you exercise a nonqualified stock option (NSO), the gain you realized from exercising the option will be taxed as ordinary income. The gain will be reported on your W-2 form at the end of the year, and both Medicare and Social Security taxes may be withheld. (The Social Security taxes will apply only if your compensation for the year has not already exceeded the Social Security taxable wage base.)

Taxed as income

NSOs are considered part of regular compensation

NSO	1,000 shares at $25 exercise price
Cost to exercise	$25,000
Stock's market value on date options are exercised	$40
Market value of 1,000 shares	$40,000
"Income" to employee	$15,000 ($40K - $25K)

Exercising the options boosts annual income

Losses incurred from sale of stock can reduce taxes

Later you may need to sell your shares at a price below the value they had on the date you exercised your option. The loss you realized will be considered a capital loss, which you can use to offset any capital gains you realized from the sale of other assets during the year. Reducing your capital gains can reduce the taxes you'll owe for the year. You can apply only up to $3,000 worth of losses each year to offset capital gains. But any "unused" losses can be carried over to following tax years. Again, remember, your cost basis in shares you acquired by exercising NSOs is their market value on the day you exercised the shares — it is not your exercise price.

Losses can be used to reduce taxes

"Unused" losses can be carried over

NSO	1,000 shares at $25 exercise price
Cost to exercise	$25,000
Stock's market value on date options are exercised	$40
Market value of 1,000 shares	$40,000
Value of shares on date you sold	$30/share
Amount you realize from sale	$30,000
Your cost basis in each share	$40/share
Your total cost basis in sale	$40,000
Your capital loss	$10,000 ($40K – $30K)
Loss you can report on year-end tax return to offset any capital gains	$3,000 (the annual limit)
Loss you can carry over to future years	$7,000 ($10K – $3K)*

*You can keep applying $3,000 per year until all losses are used up.

Be sure to keep careful records of any capital losses

Scenario 3:

You exercised incentive stock options (ISOs), and now you're facing a substantial alternative minimum tax (AMT), even though your stock has subsequently declined in value.

Incentive stock options (ISOs) are taxed differently than nonqualified stock options are in two key ways.

- With an ISO, you do not owe any income tax on the difference — or "spread" — between the exercise price of your option and the actual value of the stock on the date you exercised your option.
- The spread does have to be added to your income for the calculation of alternative minimum tax (AMT).

The rules that apply for the alternative minimum tax are different than those that apply for the calculation of ordinary income taxes. For example, when calculating AMT, you cannot deduct state income taxes, property taxes, or personal exemptions for yourself or your dependents.

If the AMT calculations produce a higher tax bill for you than ordinary income tax calculations do, then you must pay the AMT.

Your accountant can help you fully understand how the AMT works and how it may apply to your tax situation.

ISOs can complicate matters for you if they subsequently decline in value after you've exercised your option. Then you're holding an asset that is worth much less than you paid, but it could be subjecting you to a larger tax bill if the option is making the alternative minimum tax apply for you that year.

The following example demonstrates how this can happen.

ISOs can invoke the AMT

The "spread" must be included in AMT calculations

ISO	10,000 shares at $1 exercise price
Cost to exercise	$10,000
Stock's market value on date options are exercised	$10
Market value of 10,000 shares	$100,000
Spread	$90,000 ($100K - $10K)

(This amount must be added to your income for calculation of AMT)

Stock's market value several months after option exercised	$0.50 per share
Market value of stock	$5,000

The AMT can kick in even though the stock's value has depreciated.

You can make the AMT go away

When you sell stock shares you obtained through an ISO at less than the value you paid, you can report a capital loss that could reduce your taxes for the year in which you sold the stock. But this subsequent tax savings might not be enough to offset the increased taxes you have to pay in the year that your options may invoke the alternative minimum tax.

There is a step you could take to prevent yourself from being subject to the alternative minimum tax. The AMT tax applies only if the exercise of your ISO is a "qualified disposition." To meet the standards for a qualified disposition of your ISO, you must

- hold the stock for at least two years after the date that the option was granted to you by your employer
- hold the stock for at least one year after you exercise the option

If you don't meet these rules — if you sell your stock sooner than allowed — your ISO will become a nonqualified stock option. In that case:

- you will owe ordinary income tax on the "spread" between the cost of exercising the option and the market value of the stock on the day you exercised the option
- no AMT will apply

By selling the stock early, you can make the amount go away. Before undertaking such a step, however, you need to ask yourself several key questions:

- Are you and your accountant certain that the exercised ISO will subject you to the AMT?
- Does the cost of paying the AMT seem to outweigh the value of continuing to own the stock?
- Are you willing to sell the stock?
- Are you and your investment professional certain that the stock's price will not rebound enough for any gain to offset the cost of paying the AMT? (Remember, estimating the future value of a stock requires educated guesswork and no estimate can be guaranteed to be accurate.)

Reminder

If you do make a qualified disposition of stocks you obtained from an ISO and your sale price is higher than your exercise price, you will owe a long-term capital gains tax. Your cost basis in the shares will be your exercise price, and your tax will be calculated on the difference between the exercise price and the price for which you sold the shares.

Educate yourself – and turn to professional advisers

The decisions involved in exercising — and continuing to own — optioned stocks are quite complicated. You'll want to understand fully the choices available to you. Some of the additional resources listed below can help. To make sure you're making the best possible decision, professional advisers — with their wealth of expertise on these issues — can provide much-needed guidance to you and your family.

Additional resources

MFS Heritage Planning® infosheets

- Employer Stock Option Basics
- Exercising Your Corporate Stock Options

www.mystockoptions.com:
A comprehensive resource on stock compensation for employees and executives.

www.nceo.org:
The Web site for the National Center for Employee Ownership provides a wealth of information on employee stock ownership.

The returns provided in the tables above are all hypothetical results, which are provided for illustrative purposes only and are not intended to represent the future performance of any MFS fund.

Contact your investment professional for more information or to construct a personalized Heritage Planning Profile to help your parents, your children, or yourself.

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