

HOT TIP – TAXATION OF NON-STATUTORY STOCK OPTIONS AND DEFERRED COMPENSATION *

By
Donald C. Schiller
Schiller, DuCanto and Fleck

We have all understood that if an employee spouse transfers a portion of his or her stock options and retirement benefits upon divorce, the employee spouse is making a Section 1041 transfer to his or her former spouse. The former spouse then takes the employee spouse's basis for tax purposes, and there is no tax on the transfer to the former spouse. When the options are sold or exercised, the transferee/former spouse must declare the income.

Now, *Revenue Ruling* 2002-22 confirms our understanding, but creates a distinction between vested and unvested stock options and deferred compensation rights.

The issues discussed in the *Revenue Ruling* are as follows:

1. Is a taxpayer who transfers interests in non-statutory stock options and non-qualified deferred compensation plans to the taxpayer's former spouse incident to divorce required to include the amounts in gross income at the time of the transfer?
2. Is the taxpayer or the former spouse required to include an amount in gross income when the former spouse exercises the stock options or when the deferred compensation is paid or made available to the former spouse?

The facts in the *Revenue Ruling* involved an employee who was given non-statutory stock options by his employer. The options did not have a readily ascertainable fair-market

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value within the meaning of Section 1.83-7(b) of the *Income Tax Regulations* at the time the options were granted. As a result, nothing was included in the employee spouse's gross income with respect to the options at the time of the grant.

The employee spouse also maintained two unfunded, non-qualified deferred compensation plans which gave the employee spouse the right to receive post-employment payments. The employee spouse's contractual rights to the deferred compensation benefits under his two plans were not contingent on his performance of future services for the company.

Under the law of the state where the parties lived, stock options and unfunded deferred compensation rights earned by a spouse during the marriage were marital property subject to equitable division between the spouses. Pursuant to the property settlement incorporated in the 2002 divorce judgment, the employee spouse transferred one-third of the non-statutory stock options and the right to receive portions of the deferred compensation payments to the non-employee spouse. The *Revenue Ruling* then assumed that: in 2006, the non-employee spouse exercised all of the stock options and received stock with a fair market value in excess of the exercised price of the options; and in 2011, the employee spouse terminated employment and the non-employee spouse therefore received payments from both of the deferred compensation plans.

The *Revenue Ruling* discusses the fact that Section 1041(a) provides that no gain or loss is recognized on a transfer of property to a former spouse incident to divorce. Section 1041(b) provides that the property transferred is treated as acquired by the receiving spouse by gift such that the receiving spouse's basis in the property is the adjusted basis of the transferor. Although Section 1041 provides non-recognition treatment to transfers between spouses and former spouses for property, the issue of whether income derived from transferred property and paid to

the transferee is taxed to the transferor or the transferee depends upon application of the *Assignment of Income Doctrine*. The *Assignment of Income Doctrine* provides that income is ordinarily taxed to the person who earns it and that the incidents of income taxation can not be shifted by assignments. However, courts have found that applying the *Assignment of Income Doctrine* to tax the transferor spouse in divorce cases would frustrate the purpose of Section 1041 with respect to divorcing spouses and impose substantial burdens on marital property settlements involving that property.

Section 83(a) governs non-statutory stock options that do not have a readily ascertainable fair market value on the date they are granted. Section 83 does not apply to the grant of non-statutory stock options at the time of the grant but applies to property received when the option is exercised or to any money or other property received in an arm's length disposition of the option. See Section 83(e) and Section 1.83-7(a). The *Revenue Ruling* does specify that non-statutory stock options would be afforded the same Section 1041 treatment to require the transferee spouse to pay taxes on any gain realized on the exercise of the option and states that the *Assignment of Income Doctrine* does not apply to the transfers such that the transferee spouse would need to declare income upon the payment of the deferred compensation.

So far so good, but the conclusion of the *Revenue Ruling* goes on to state explicitly that the non-recognition treatment and the exemption from applying the *Assignment of Income Doctrine* do not apply to transfers of non-statutory stock options, unfunded deferred compensation rights or other future income rights to the extent such options or rights are unvested at the time of transfer or to the extent that the transferor's rights to such income are subject to substantial contingencies at the time of the transfer. See *Kochansky v. Commissioner*, 92 F.3d 957 (9th Cir. 1996). Although transfers of certain types of property incident to divorce

whose tax consequences are governed by a specific provision of the code or regulations will not be affected by this ruling, there are other types of unvested or contingent rights which may constitute marital property which the courts divide on an "if, as and when received" basis. These types of assets would be taxed to the transferor spouse under application of this *Revenue Ruling*.

The Hot Tip is that if there are unvested benefits of any kind or other future income rights that are subject to contingencies at the time of transfer, include provisions in your Marital Settlement Agreement specifically indicating how the spouses will treat these items for purposes of Federal and State Income Taxation. The following is my suggested sample language:

Tax Treatment of Non-Statutory Stock Options/Unfunded Deferred Compensation/Other Future Income Rights Transferred Incident to Divorce.

In the event that all or any part of the property and/or income to be earned and received pursuant to Paragraph _____ of this Marital Settlement Agreement is not so includible by the (name of transferee spouse) and is deemed taxable to the (transferor spouse), whether by Internal Revenue Service interpretation, amendment or repeal of existing revenue statutes, by case law or otherwise, then the (transferee spouse) shall pay to the (transferor spouse) an amount equal to the transferor's spouse's tax detriment as a result of tax treatment not intended by this Marital Settlement Agreement.