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Tax Consequences of Distributing Equity Compensation Rights in Divorce

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When a corporate executive is divorced, a large proportion of the marital estate may be in the form of equity compensation, such as stock options and restricted stock. The equitable division of equity compensation implicates technical tax issues and also creates tax planning opportunities. This Article discusses these issues and opportunities.

I. Taxation of Equity Compensation

In the context of corporate issuers (as opposed to partnership, LLC, or other noncorporate issuers), "equity compensation" refers to compensation whose value is related to the stock value of the employer. The most common forms of equity compensation are stock options and restricted stock.

A. Stock Options

A stock option is the right to purchase a share of stock at a specified price (referred to as "strike price") during a specified period. Compensatory stock options usually become exercisable ("vest") pursuant to a fixed schedule. Typically, compensatory stock options have a strike price equal to the fair market value of the underlying stock at the time of grant[1] and have a vesting period of three to five years, with options vesting ratably over the period.

In general, there are no tax consequences to the employee upon the grant or vesting of compensatory options.[2] Upon exercise of an option, the employee recognizes compensation income equal to the spread between then-existing value of the underlying stock and the strike price.[3] The income that the employee recognizes is characterized as ordinary income for federal income tax purposes and wages for federal employment tax purposes. This means that the

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combined federal tax rate that applies to the spread can exceed 40 percent.[4] The employee's basis in the shares received pursuant to the option exercise equals the fair market value of the shares. Therefore, if an employee exercises and then immediately sells the underlying stock, the employee will not recognize any further income on the sale of the stock.

B. Restricted Stock

Restricted stock is the other most common type of equity compensation issued by corporations. Restricted stock is employer stock that is transferred to the employee for free (or at a discount) subject to a vesting schedule. The vesting schedule requires that the employee remain employed by the employer for a specified period of time in order to keep the stock. As with stock options, the issuer has great flexibility in designing the vesting arrangement, but restricted shares typically vest ratably over a three to five year period.

Restricted stock is generally taxable upon vesting,[5] with the amount of the employee's income based on the fair market value of the stock at that time.[6] Thus, for example, if restricted stock with a value of $10 is transferred for free to an employee in Year 1, and the stock vests in Year 2 when it is worth $15, the employee realizes no income in Year 1 because the stock did not vest in that year. In Year 2, the employee realizes $15 of compensation income because the stock vested in that year, at the time of vesting the stock was worth $15, and the employee had paid no consideration for the stock.

C. Summary

These tax consequences are summarized in the following table:

Type of Equity Comp	**Taxable Event**	**Character of Income**
Options	Exercise	Compensation

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Restricted Stock	Vesting	Compensation

The common tax theme to both of these equity compensation arrangements is tax deferral. While the rights to the eventual income are earned through the performance of services over a period of time, the taxable event (exercise in the case of options, vesting in the case of restricted stock) occurs after some or all of those services have been performed.

This deferral can create complications (and tax planning opportunities) when a divorce-related transfer of the property is made before the taxable event occurs. Thus, stock options may be transferred between grant (or vesting) and exercise, and restricted stock may be transferred between grant and vesting.

II. Section 1041 and the Assignment of Income Doctrine

Internal Revenue Code Section 1041[7] generally provides that divorce-related transfers of property are tax-free and that the transferee spouse takes such property with a carryover basis from the transferor spouse. Congress enacted this rule to "make the tax laws as unintrusive as possible with respect to relations between spouses."[8] Section 1041 clearly applies to nearly all kinds of property commonly transferred in a divorce, such as houses, cars, jewelry, and investment property.

However, the application of Section 1041 to equity compensation items is not as clear because of its potential conflict with the common law assignment-of-income doctrine, which prevents the shifting of income tax liability through gratuitous transfers. For example, in the classic assignment-of-income case of *Lucas v. Earl*, 281 U.S. 111 (1930), the United States Supreme Court held that a husband was taxable on 100 percent of his compensation income even though he had previously contracted to give half of such compensation to his wife. The Supreme

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Court explained that "tax could not be escaped by anticipatory arrangements and contracts however skillfully devised to prevent the salary when paid from vesting even for a second in the man who earned it."[9]

The conflict between Section 1041 and the assignment of income doctrine was addressed in the Ninth Circuit Court of Appeals case of *Kochansky v. Commissioner*, 92 F.3d 957 (9th Cir. 1996). In that case, a personal injury lawyer had entered into a contingent fee agreement with a medical malpractice client. During the course of the litigation, the lawyer was divorced and, in connection with the divorce, transferred a one-half interest in the contingent fee to his ex-wife. The medical malpractice case was subsequently settled, and half of the contingent fee was remitted to the ex-wife. The tax issue was whether the personal injury lawyer was taxable on the entire fee or only the one-half portion that he had not transferred to his ex-wife. Citing to *Lucas* and other assignment-of-income cases, the Ninth Circuit held that the entire fee, including the portion that had been transferred incident to the divorce, was taxable to the personal injury lawyer.[10]

Because of the conflict between Section 1041 and the assignment of income doctrine, the taxation of equity compensation transferred in connection with a divorce was historically very unclear. Section 1041 would make the transferee spouse liable for tax when the taxable event when options are exercised or restricted stock vests post-divorce, while the assignment of income doctrine would impose tax on the transferor spouse. In 2002, the IRS issued Revenue Ruling 2002-22,[11] which clarified the issue with respect to divorce-related transfers of vested equity compensation, though questions remain about transfers of unvested equity compensation.

III. Transfers of Vested Options

Revenue Ruling 2002-22 provides that, if vested options are transferred in connection with a divorce, the transfer constitutes a transfer of property under Section 1041. (The transfer of vested restricted stock is simply a transfer of stock, to which Section 1041 clearly applies.) Accordingly, the transfer of vested options is not a taxable event, and the transferee spouse receives a carryover basis of zero in the option. Thereafter, when the transferee exercises the option, the transferee realizes compensation income equal to the spread.

From a tax perspective, therefore, the transferee of a vested option effectively steps into the transferor's shoes. For reporting and withholding purposes, the employer reports the income upon exercise by the transferee on a 1099-MISC and makes supplemental withholding at the appropriate flat rate; the withheld amounts are credited against the transferee's year-end income tax liability.[12]

While Revenue Ruling 2002-22 clarified the *income* tax consequences of transfers of vested options, the ruling did not address the associated employment tax consequences. The IRS subsequently issued Revenue Ruling 2004-60, which explained that, for employment tax purposes, the income realized by the transferee (nonemployee) spouse upon exercise is treated as wages of the transferor (employee) spouse. [13] Accordingly, upon exercise of the option, the resulting income will be shown on the transferor/employee spouse's W-2 as wages and will therefore be subject to employment tax withholding at that spouse's employment tax rate. That tax rate depends on the amount of the transferor's wages to date at the time of the exercise. In 2013, the first $113,700 of wages are subject to an employment tax rate of 7.65 percent; the next $86,300 ($136,300 if the taxpayer is married filing jointly) is subject to a 1.45 percent rate; and all remaining wages are subject to a 2.35 percent rate.

Typically, holders of compensatory stock options exercise and then immediately sell the underlying stock. In addition, holders commonly engage in a "cashless exercise," whereby they borrow the strike price from the employer and then repay the loan out of the sales proceeds from the sale of the underlying stock. The end result is that upon cashless exercise by the transferee/nonemployee spouse, the employer remits that spouse a check equal to the spread between the value of the stock and strike price reduced by supplemental withholding (at the appropriate flat rate) and employment tax withholding (calculated using the transferor/employee's wages to date).

Under these revenue rulings, while the income tax burden is always borne by the transferee/nonemployee spouse, the incidence of the employment tax burden is not clear because the tax is calculated by reference to the employee spouse's W-2 wages. Accordingly, marital settlement agreements should make clear that, despite this feature, the transferee/nonemployee spouse will bear the burden of all taxes resulting from exercise of an option or payout of a stock appreciation right. This is the result that occurs automatically under the cashless exercise procedure described above.

IV. Transfers of Restricted Stock and Unvested Stock Options

While Revenue Ruling 2002-22 clarified the treatment of vested options, it explicitly exempted unvested rights from its scope:

> This ruling does not apply to transfers of nonstatutory 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).[14]

This carve-out applies to unvested stock options, which are specifically mentioned, and also apparently to restricted stock because these are "future income rights" that are unvested at the time of transfer.

While the carve-out is not a paragon of clarity, the citation to *Kochansky* seems to imply that, if these unvested rights are transferred in connection with a divorce, the transferor remains taxable upon the subsequent taxable event under the assignment-of-income doctrine. This is exactly what happened in *Kochansky*, where the personal injury lawyer transferred half of his unmatured contingent fee rights to his spouse, who later collected half of the fee when the case was settled. In that case, the Ninth Circuit held that the personal injury, not the transferee spouse, was liable for the tax on the transferee spouse's share. On the other hand, the carve-out could be viewed as merely bracketing off the unvested compensation issue for further study, though the citation to *Kochansky* seems to go further than that.

A recent private letter ruling[15] has further muddied the water regarding divorce-related transfers of unvested equity items. In Private Letter Ruling 2010-16-031,[16] the IRS ruled that restricted stock transferred pursuant to a divorce was taxable to the transferee spouse upon vesting, which is totally inconsistent with *Kochansky*. The ruling discusses Revenue Ruling 2002-22 but does not mention the ruling's carve-out for unvested rights, nor does the ruling mention or cite *Kochansky*. The Private Letter Ruling's conclusion was the result desired by the parties, and the divorce decree explicitly provided that (i) the parties intended "a result consistent with Revenue Ruling 2002-22" and (ii) the transferee spouse was "responsible for paying all costs attributable to [the transferee's] allocation of restricted stock, including taxes other than [employment] taxes."[17] The Private Letter Ruling therefore implies that the carve-out language in Revenue Ruling 2002-22 was just bracketing off the unvested equity compensation issue and that that the IRS has now determined that the revenue ruling's approach applies to all equity compensation items transferred in connection with a divorce whether vested or not. There are two concerns that temper this conclusion. First, private letter rulings do not constitute binding precedent on the IRS except with regard to the particular taxpayers to whom they are issued.[18] Second, the Private Letter Ruling includes no analysis whatsoever of the unvested issue, which suggests that the IRS has not yet reached a reasoned determination on the issue.

Given this ambiguity, what is a divorce practitioner to do? The easiest approach would be to avoid transferring unvested items in the first place. If an equitable distribution can be accomplished by transferring only non-compensation items and vested compensation items, then the ambiguity is avoided. If a large batch of equity compensation is scheduled to vest in the near term, it might be worth delaying the effective date of the divorce to allow that batch to vest and be transferred without implicating the ambiguity. Another option would be to request a private letter ruling from the IRS.[19] Seeking such a ruling will involve some additional cost and could take several months, though the fact that the IRS has already issued a short ruling on the issue should make the process quicker and less expensive. If large amounts of unvested items will be transferred and delay is not a significant concern, the private letter ruling option should be considered.

If unvested compensation items must be transferred and a private letter ruling request is not feasible, the most conservative approach would be for the parties to agree that the transferor spouse will (consistent with *Kochansky*) report the income and employment tax resulting from the taxable event, but that the transferee spouse will bear the economic burden of the tax. To implement this structure, the parties could use a constructive trust arrangement, whereby the transferor spouse retains legal title to the unvested items for the benefit of the transferee spouse.

In the case of stock options, the transferor would agree to exercise the options and sell the underlying stock at the direction of the transferee and transfer the after-tax proceeds. In the case of restricted stock, the transferor spouse would transfer the after-tax amount of shares after vesting.

A constructive trust would probably not alter the fact that the unvested items have been transferred for tax purposes, because legal title is not dispositive as to tax ownership. Nevertheless, this approach has a number of attractive features. First, the tax treatment is most consistent with Revenue Ruling 2002-22's explicit carve-out of unvested items and its citation to *Kochansky*. Second, some employers preclude or discourage employees from transferring unvested compensation items even in a divorce. This would make a constructive trust feature a necessity. Third, because legal title to the items remains in the hands of its employee and the eventual tax consequences are reported on the employee's W-2, the employer's procedures for tax reporting are unaffected. Fourth, because both spouses have agreed to report the unvested items consistently, there is no risk of IRS whipsaw through inconsistent positions, which means the IRS should respect the parties' agreement (which as noted above appears consistent with Revenue Ruling 2002-22).

The suggested constructive trust arrangement should include some technical provisions to ensure that the parties receive the results that they expect. First, the transferor spouse, who has agreed to report the income from the unvested item upon the appropriate taxable event, should indemnify the transferee spouse if the IRS decides that the Revenue Ruling 2002-22 methodology is appropriate even for unvested options. This will ensure that transferee spouse is not effectively doubly taxed on the item (first by receiving only the after-tax proceeds and again when the IRS asserts a deficiency against the transferee spouse). The indemnity will also ensure that the transferor spouse does not receive a windfall. It will also discourage the transferor spouse from making an opportunistic refund claim asserting that the Revenue Ruling 2002-22 methodology applies to unvested items because any gains from such a claim will be offset by liability for indemnity.

Second, to calculate the after-tax payments that go to the transferee spouse upon vesting or exercise, the transferor's effective marginal tax rate needs to be determined.[20] Since the rate will be known with accuracy only after the end of a taxable year and because withholding rates may differ from a taxpayer's ultimate marginal tax rate, a stipulated or assumed rate can be used. For very high-income taxpayers, "the highest effective marginal federal income and employment tax rate on wages for individuals then in effect" could be utilized. Alternatively, an actual percentage, such as 42.8%, which is the current maximum effective rate on wages for Florida residents,[21] can be specified, but tax law changes could make a specific percentage rate obsolete in future years. If the taxpayer is subject to state or local taxes, these should be built into the assumed rate as well. There are two advantages to using a stipulated or assumed tax rate instead of determining the actual tax rate on an ex post basis. First, it gives both parties clarity as to the amount of taxes to be withheld upon each transfer of money from the transferor spouse to the transferee spouse. Second, using a stipulated rate avoids the need for the transferor spouse to periodically share his or her post-dissolution tax returns with the former spouse for the purpose of determining the actual effective marginal tax rate. In the event that a stipulated tax rate cannot be negotiated, then the parties can agree to exchange tax documents and to make true up payments after the end of the year once the actual marginal tax rate is calculated.

V. Conclusion

Equity compensation items can result in both planning opportunities and technical headaches for divorce practitioners. The tax burden from the transfer of vested stock options now clearly falls on the transferee spouse. If the nonemployee spouse is expected to be in a lower marginal tax bracket than the employee spouse, then transferring vested stock options is an attractive tax strategy because it reduces the parties' aggregate tax liabilities.

While vested stock options create planning opportunities, unvested options and restricted stock create complications. It is unclear which spouse will bear the income tax liability when these options are exercised and when restricted stock vests. Given this uncertainty, the best course of action is to avoid transferring these items if possible. If these items must be transferred, the constructive trust approach described in this article should be considered.

[1] Since the 2004 enactment of Section 409A of the Internal Revenue Code, 26 U.S.C.S. § 409A (Lexis 2013), which generally harshly taxes stock options with a strike price below fair market value at the time of grant, in-the-money option grants are exceedingly rare.

[2] There is one exception to this rule: if an option is deemed to have a readily ascertainable fair market value upon grant, then the employee will realize income upon vesting or grant. However, it is highly unusual for compensatory options to be considered to have a readily ascertainable fair market value upon grant.

[3] This conclusion assumes that the option is not an "incentive stock option" covered by Section 423. 26 U.S.C.S. § 423 (Lexis 2013). The vast majority of compensatory stock options are not incentive stock options. In addition, if an incentive stock option is transferred (whether in connection with a divorce or not), the option automatically loses its status as an incentive stock option and would be taxed as described above.

[4] The top federal income tax rate is 39.6 percent and the employee's share of the Medicare tax is at least 1.45 percent.

[5] Restricted stock recipients can make an election under Section 83(b) of the Internal Revenue Code, 26 U.S.C.S. § 83(b) (Lexis 2013), to the granting of restricted stock the taxable event (with the amount of compensation determined by the value of the stock at that time), but this election is often not made. If a Section 83(b) election is properly made, then the stock is treated as fully vested stock and, if that stock is thereafter transferred in connection with a divorce, the transferee would simply take the stock with a carryover basis.

[6] If the restricted stock was granted for free, then the employee would include the full value in gross income; if the restricted stock was purchased by the employee, then the employee would include the excess of the value over the purchase price in gross income. If the stock never vests, then there are no tax consequences.

[7] 26 U.S.C.S. § 1041 (Lexis 2013)

[8] H.R. Rep. 98–432 at 1491 (March 5, 1984).

[9] *Lucas v. Earl*, 281 U.S. 111, 114–115 (1930).

[10] *Kochansky v. Commr.*, 92 F.3d 957, 958 (9th Cir. 1996).

[11] Rev. Rul. 2002-22, 2002-19 I.R.B. 849.

[12] Rev. Rul. 2004-60, 2004-24 I.R.B. 1051.

[13] *Id.*

[14] 2002-19 I.R.B. at 851.

[15] A private letter ruling is "a written statement issued to the taxpayer in which interpretations of the tax laws are made and applied to a specific set of facts. The function of the letter ruling, usually sought by the taxpayer in advance of a contemplated transaction, is to advise the taxpayer regarding the tax treatment he can expect from the IRS in the circumstances specified by the ruling." *U.S. v. Wahlin*, 384 F. Supp. 43, 46 (W.D. Wis. 1974).

[16] Priv. Ltr. Rul. 2010-16-031 (Apr. 23, 2010).

[17] *Id.* at 2.

[18] *Bookwalter v. Brecklein*, 357 F.2d 78, 82 (8th Cir. 1966); *Lucky Stores, Inc. v. Commr*, T.C. 70, n. 5 (1997) (stating "Taxpayers other than those to whom [private letter rulings] or memoranda were issued are not entitled to rely on them").

[19] For instructions for how to obtain a private letter ruling, *see* Internal Revenue Service, *Question: How Would I Obtain a Private Letter Ruling?*, http://www.irs.gov/Help-&-Resources/Tools-&-FAQs/FAQs-for-Individuals/Frequently-Asked-Tax-Questions-&-Answers/IRS-Procedures/Code,-Revenue-Procedures,-Regulations,-Letter-Rulings/Code,-Revenue-Procedures,-Regulations,-Letter-Rulings (Jan. 8, 2013).

[20] Effective marginal tax rates can be tricky to determine with precision because of "hidden" tax rate increases buried in the tax code. For instance, section 68 of the Code, while purporting to reduce the itemized deductions of high-income taxpayers, is effectively a tax rate increase; for the taxpayers paying the highest income tax rate of 39.6%, section 68 increases the marginal tax rate by 1.19%.

[21] *See* Gerald T. Prante & Austin John, *Top Marginal Effective Tax Rates by State and by Source of Income, 2012 Tax Law vs. 2013 Tax Law (as enacted in ATRA)*, Soc. Sci. Research Network (Feb. 3, 2013) (available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2176526).