

IRS RULES ON TAXATION OF STOCK OPTIONS TRANSFERRED PURSUANT TO DIVORCE

The IRS has ruled that a court's recognition of X's (divorced spouse) community property interest in incentive stock options under which E (former spouse) could only exercise the ISOs in accordance with X's instructions did not violate the requirements of the Code with respect to non-transferability and lifetime exercise by an employee.

■ **The facts**

Prior to the date of E's separation, E's employer granted nonstatutory (NSOs) and statutory options (ISOs) to E under the company plan. Some of the options vested prior to the date of separation, some vested after the date of separation and some of the options remain unvested. The ISO agreement provided the ISOs may not be transferred other than by the laws of descent and distribution, and may, during E's lifetime, only be exercised by E. The NSO agreement (NSO) stated the NSOs may only be exercised by E or by a transferee under a qualified domestic relations order. The NSOs did not have a readily ascertainable fair market value on the date of grant.

The court judgment provided that X's ISOs will remain in E's name, but that X will retain all legal and beneficial ownership of X's ISOs to the extent consistent with the non-transferability and employee exercise rules under the Code. The judgement also required X's NSOs, including unvested NSO's subject to the same vesting schedule, be fully transferred to X, as permitted by the employer and its plan. E will exercise X's ISOs (and any of X's NSOs remaining in E's name) only in accordance with X's written instructions and only if X pays or makes acceptable arrangements for the payment of the exercise price and all costs of the transaction. In addition, the stock must be transferred directly to X upon exercise unless the stock subject to the options was to be immediately sold. The income and employment taxes attributable to the stock will either be paid by X or paid by the withholding of shares.

■ **The law**

At issue was the tax consequences of this transaction. ISOs are accorded special tax treatment. In general, with respect to an ISO, no income is realized at the time of the grant or the exercise of the option. It is only when the stock which is the subject of the option is later sold that income may be realized. Under the Code, an option does not qualify as an ISO unless such option by its terms is not transferable by the employee, other than by will or the laws of descent and distribution, and is only exercisable by the employee during his lifetime.

The Code, in part, no gain or loss will be recognized on a transfer of property from an individual to a former spouse, but only if the transfer is incident to the divorce. In a Revenue Ruling, the IRS held a taxpayer who transferred interests in NSOs to his former spouse incident to divorce was not required to include an amount in gross income on the transfer. Rather, the former spouse was required to include an amount in gross income when the former spouse exercised the stock options.

■ **The ruling**

With respect to the ISOs, the IRS said the transferability and lifetime exercise requirements were not violated by the fact that E exercised the ISOs on X's behalf and X's portion of the ISO's remained in E's name. Additionally, when X's ISOs are later exercised and the stock is transferred to X, there is no disposition of the stock. However, on subsequent disposition of the ISO stock (assuming the holding period requirements have been met), capital gain or loss will be recognized by X with respect to the stock received on exercise of X's ISOs. The IRS also held the transfer of the NSOs to X will not be treated as a disposition of those options and X must report the compensation income when those options are exercised.

The IRS said that, under principles regarding taxation of equal division of community property, none of the following will be a taxable event: (i) the recognition of X's ownership of X's options; (ii) the transfer to X of X's NSOs; (iii) the transfer of stock from E or E's employer to X after the exercise by E of any of X's options; or (iv) E's designation of X as beneficiary of X's options. X is entitled to the credit for income tax withheld from the stock or cash proceeds (or paid to E's employer by X for properly due income tax withholding) at the time of the exercise of the NSOs of which X is the beneficial owner.

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