

VALUATION OBSERVATIONS

*Some practical observations from a practicing
business appraiser.*

VLC

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STOCK OPTIONS AND DIVORCE

Stock options have become very popular as a creative method of compensating employees without draining the business's cash flow. Like other investments, stock options are property subject to division in a divorce.

The IRS issued Letter Ruling 200005006 on November 1, 1999 stating that incentive stock option transfers from a husband to his ex-wife pursuant to a divorce resulted in income for the husband when the options were transferred. But doesn't this fly in the face of the Section 1041 rules that are so well known and widely relied upon?

Section 1041 provides that no gain or loss shall be recognized on a transfer of property between spouses if the transfer is incident to divorce. However, the income to be recognized by an employee from stock options is compensation income (i.e. ordinary income), not gain on sale. Therefore, section 1041 does not apply to stock options.

But wait. Isn't there a difference between Incentive Stock Options (ISO's) and Non-Qualified Stock Options (NQSO's)? When an incentive stock option is exercised, there is no income recognized for regular income tax. There are, however, AMT tax considerations. When a non-qualified stock option is exercised, the optionee recognizes compensation income equal to the excess of the FMV of the stock over the amount paid to acquire it. Pursuant to Section 422, incentive stock options are not transferable except by laws of descent and distribution. Therefore, a transfer incident to divorce transforms the incentive stock option to a non-qualified stock option. This is known as a disqualifying disposition.

What this all means is that the employee must recognize ordinary income in the amount of the FMV of the stock less the exercise price at the time of the transfer to his/her ex-spouse. The amount of this recognized income (compensation) becomes the adjusted basis in the option to the ex-spouse. This compensation is taxable income subject to income tax and payroll taxes to the employee in the year of the transfer, even if there is no money to pay it.

There are no tax consequences to the ex-spouse at the time of the transfer. When the ex-spouse exercises the options, neither party is subject to any tax consequences. This is so because the transfer incident to divorce is equivalent to exercise of a NQSO, and taxed as such. Any amount paid as the exercise price becomes additional basis to the ex-spouse. Upon final sale of the stock, the ex-spouse will recognize capital gain or loss and pay taxes accordingly.

The determination of the proper taxpayer revolves around the question of which person in fact controls the earning of income, rather than who ultimately receives the income. The transferor (employee) controlled the option up until the time of the transfer. Thus, he is taxed on the transaction (transfer) at that time. After the transfer, the transferee (ex-spouse) controlled the option exercise and ultimate stock sale. As such, she is taxed on the sale of the stock.

It is important to avoid accidentally converting an ISO into a nonqualified stock option through a divorce-related transfer. To protect our clients from these adverse tax consequences, clients should consider exercising them before the divorce (assuming that is allowed under their plan). The subsequent transfer of the resulting stock to the ex-spouse incident to a divorce will then benefit from Section 1041. If this can be accomplished, the only tax consequences will be capital gain to the ex-spouse on the difference between the sale price and the exercise price, rather than (1) compensation income to the employee for the difference between the FMV and exercise price at the time of the transfer and also (2) capital gain to the ex-spouse for the difference between the income recognized by the employee plus exercise price and the sale price.

One additional issue to keep in mind is that option's value is not the adjusted basis for tax purposes, but is discounted to account for such risk factors as the stock price's volatility between the transfer date and the date of exercise.

If you would like additional information, or have a question, please do not hesitate to call.

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Terri Lastovka is the founder of Valuation & Litigation Consulting, LLC. Her practice focuses on business valuations and litigation consulting in the areas of domestic relations, gift and estate tax, probate, shareholder disputes, economic damages, and forensic accounting. She draws from a wide range of experiences, including public accounting, law, banking, and CFO. She has received extensive training from the American Society of Appraisers in the area of business valuation and works closely with members of the bar to effectuate practical settlements. Terri also serves as the Director of Legal & Finance for Journey of Hope, a grass roots non-profit organization providing financial support to cancer survivors.