

# *VALUATION OBSERVATIONS*

*Some practical observations from a practicing  
business appraiser.*

*VLC*

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## **STOCK OPTIONS TRANSFERRED PURSUANT TO DIVORCE REVISITED**

Stock options are confusing enough, but now the IRS has changed its approach on how they are taxed. Let's first refresh ourselves as to what these charming little employee benefits are.

Incentive stock options (ISO's) are a form of equity compensation that provides unique tax benefits — and comes with significant tax complexity. When an incentive stock option is exercised, there is no income recognized for regular income tax. Capital gains tax will be recognized when the stock is eventually sold. However, ISO's have numerous restrictions, the most important being that they 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 (NQSO). This is known as a “disqualifying disposition.”

Non-qualified stock options have two disadvantages compared to incentive stock options. One is that you have to report taxable income at the time you exercise the option to buy stock, and the other is that the income is treated as compensation, which is taxed at higher rates than long-term capital gains.

Now, back to the IRS. The rule used to be that the employee spouse recognized compensation income (i.e. wages) which was subject to income tax and payroll taxes in the year of the transfer. There were no tax implications to the ex-spouse at the time of transfer or at the time of exercise. Not until the stock was eventually sold, did capital gains tax come in to play.

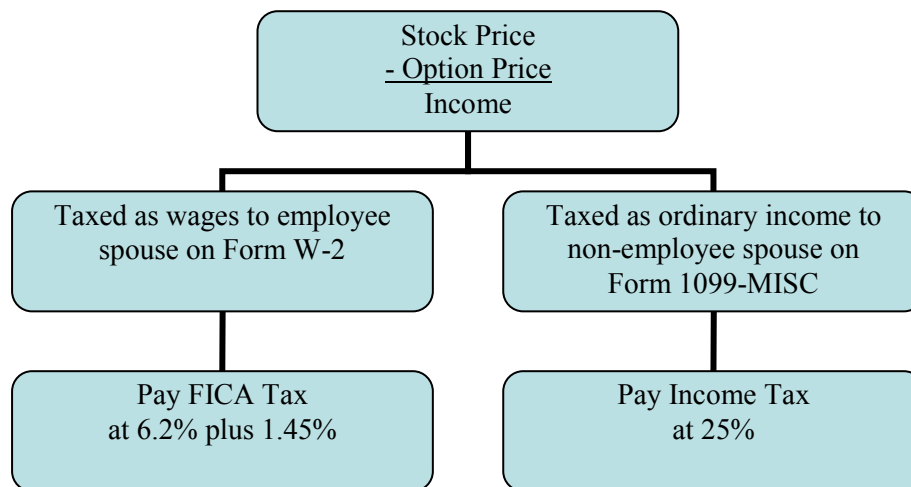
Effective January 1, 2005 (pursuant to Revenue Ruling 2004-60), the transfer of interests in NQSO's from an employee spouse to a non-employee spouse incident to a divorce does not result in income at the time of transfer, but at the time of exercise by the non-employee spouse. The NQSO's will be subject to payroll taxes (FICA and FUTA) to the same extent as if the options had been retained by the employee spouse and exercised by the employee spouse.

### Tax impact on employee spouse

The difference between the option's exercise price and the stock price is considered wages of the employee spouse for payroll tax purposes because they are related to services provided by the employee spouse. The employee portion of the FICA taxes is deducted from the "wages" and is also deducted from the payment to the non-employee spouse. The social security portion of the FICA tax is 6.2% for wages not exceeding \$94,200 in 2006. The medicare portion of the FICA tax is 1.45% with no limit.

### Tax impact on non-employee spouse

The income recognized by the non-employee spouse with respect to the exercise of the NQSO's is subject to income tax withholding. Since the recipient is not an employee, the statutory flat rate withholding method on supplemental wages is utilized, which is currently 25%.



Prior to 2005, the employee spouse paid both the payroll tax and income tax at the time of transfer. Now, the employee spouse pays only payroll tax, and not until time of exercise of the option by the non-employee spouse. And the non-employee spouse pays the income tax at the time of exercise of the option.

The employee spouse receives a Form W-2 reporting social security wages, medicare wages, social security taxes withheld, and medicare taxes withheld, but no amount is includible in the boxes where wages are reported for income tax purposes. The non-employee spouse receives a Form 1099-MISC reporting income and income tax withheld.

Additionally, the division/transfer of options incident to divorce are considered to be made for full and adequate consideration in money or money's worth and will not be a taxable gift. (PLR 200519011 and *Harris v. Commissioner*, 340 U.S. 106 (1950)).

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.