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Taxing Compensatory Stock Rights Transferred in Divorce

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TAXING COMPENSATORY STOCK RIGHTS TRANSFERRED IN DIVORCE*

GREGG POLSKY** & KATHLEEN DELANEY THOMAS***

Stock-based compensation has become increasingly prevalent in recent years. As a result, many high net worth divorces now result in the transfer of compensatory stock rights from the employee spouse to the nonemployee spouse as part of the marital settlement. Despite this growing trend, the tax consequences of these transfers have not yet been explored fully. This Article endeavors to fill this void and explain both the planning opportunities and potential pitfalls in transferring compensatory stock rights in divorce. These transfers can shift ordinary income from a high-bracket spouse to a lower-bracket spouse, creating a tax surplus that enlarges the marital estate. On the other hand, these transfers can result in counterintuitive tax consequences because the income tax effects are surprisingly inconsistent with the employment tax effects. This inconsistency can lead to misunderstandings about which party is intended to bear the burden of these taxes. In addition, despite recent IRS guidance in this area, the taxation of transfers of unvested stock rights remains highly uncertain. In light of the opportunity for income shifting, the potential for confusion, and the continuing legal uncertainty, tax and legal advisors on both sides of a

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** Willie Person Mangum Professor of Law, University of North Carolina School of Law & Visiting Professor of Law, Duke University School of Law (2014–15). We are delighted to participate in this issue of the *North Carolina Law Review* honoring Professor William Turnier's long and distinguished career as a tax professor at our institution, the University of North Carolina School of Law. We believe that this Article is particularly appropriate to honor Bill's contributions to both our law school and the broader legal academic community. Bill has always encouraged legal scholarship with a practical orientation that can tangibly benefit lawyers, law teachers, judges, and policymakers, and we set out to write this Article with those goals in mind. *See generally* William J. Turnier, *Tax (and Lots of Other) Scholars Need Not Apply: The Changing Venue for Scholarship*, 50 J. LEGAL EDUC. 189, 212 (2000) (noting how legal scholarship can benefit practitioners, law teachers, judges, and policymakers and arguing that "[o]n the policy front legal tax scholars can make valued contributions when they do what lawyers do best: provide advice on the means by which desired goals can best be implemented"). In addition, the topic of the Article is apropos, as one of Bill's favorite courses to teach (and perhaps his most popular course with students) was Family Wealth Management. We thank Alfred Brophy, Emily Cauble, Brant Hellwig, Robert Smith, and Lawrence Zelenak for their helpful comments and suggestions.

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divorce must be extremely careful when stock rights are part of the marital estate.

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INTRODUCTION

Over the past thirty years, there has been a veritable explosion in the amount of incentive compensation paid to senior executives of

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public corporations, both in nominal terms and relative to salary compensation.¹ The conventional wisdom is that performance-based pay is necessary to better align managerial incentives with the desires of shareholders.² The most common form of incentive compensation is stock-based compensation, such as stock options and restricted stock.³

Given this trend in favor of stock-based compensation, it is not surprising that compensatory stock rights are transferred from the employee spouse to the nonemployee spouse in many high net worth divorces. Yet, despite the prevalence of both stock-based pay and divorce⁴ in the United States, the tax consequences of these transfers have not yet been explored fully. This Article endeavors to fill this void and explain both the planning opportunities and potential pitfalls in transferring compensatory stock rights in divorce.

Such transfers can be beneficial to both parties if they can shift income from a higher-bracket spouse to a lower-bracket spouse, creating a “tax surplus”⁵ that can be shared by the parties. However, which party bears the burden of the tax on income from stock rights transferred in divorce is not always clear. Guidance from the IRS has clarified that income from *vested* stock rights—such as vested stock options—that are transferred in divorce is properly taxable to the transferee spouse.⁶ However, that guidance did not clarify the proper treatment of income from *unvested* stock rights transferred in divorce, and case law appears to suggest that the transferor may remain taxable on such income.⁷ Further complicating matters is the fact that the IRS requires that employment taxes be paid by reference to the

1. See David I. Walker, *The Law and Economics of Executive Compensation: Theory and Evidence*, in RESEARCH HANDBOOK ON THE ECONOMICS OF CORPORATE LAW 232, 235 (Claire A. Hill & Brett H. McDonnell eds., 2012).

2. See Andrew C.W. Lund & Gregg D. Polsky, *The Diminishing Returns of Incentive Pay in Executive Compensation Contracts*, 87 NOTRE DAME L. REV. 677, 682–86 (2011) (explaining the purported agency cost reductions resulting from incentive compensation).

3. See Walker, *supra* note 1, at 237 (noting that “equity compensation accounts for well over half of the aggregate ex ante value of executive pay at large public companies” and that “equity compensation is viewed as particularly important in aligning managerial and shareholder incentives”).

4. From 2000 through 2011, there were approximately 900,000 divorces and annulments per year in the United States. See *National Marriage and Divorce Rate Trends*, CENTERS FOR DISEASE CONTROL & PREVENTION, http://www.cdc.gov/nchs/nvss/marriage_divorce_tables.htm (last updated Feb. 19, 2013) (excluding a few states).

5. A “tax surplus” is the tax that is saved from shifting income from a higher-bracket spouse to a lower-bracket spouse can be shared by the parties by adjusting the amount of income transferred.

6. Rev. Rul. 2002-22, 2002-1 C.B. 849.

7. See *infra* text accompanying notes 73–82.

transferor spouse's wages even when the transferee spouse bears the tax on income from vested stock rights transferred in divorce.⁸

Due to the legal uncertainty surrounding transfers of stock rights in divorce, particularly transfers of unvested stock rights, this Article makes a number of tax-planning recommendations to assist taxpayers and their advisors. It first suggests that parties avoid transfers of unvested stock rights, if possible, or delay any such transfers until vesting. If those options are not feasible, we recommend that the parties seek a private letter ruling or, as an alternative, adopt a constructive trust approach in which the transferor spouse bears the nominal tax burden on income from unvested stock rights while the economic burden is borne by the transferee spouse.

We then offer recommendations for legal reform, suggesting that the government issue binding guidance clarifying which party is properly taxed on income arising from unvested stock rights transferred in divorce. Current case law appears to require that the transferor should bear the tax burden, though the issue is not entirely free from doubt. However, to simplify matters for the parties and to enable consistent treatment between vested stock rights and unvested stock rights, we suggest that the IRS issue a safe harbor allowing the parties to agree that the transferee spouse will pay the tax on income from unvested stock rights transferred in divorce.

This Article proceeds as follows. Part I discusses the general taxation of compensatory stock rights, including restricted stock, stock options, and contractual stock-based rights (i.e., stock appreciation rights and phantom stock units). Part II describes the general tax treatment of divorce-related property transfers. Part III then analyzes the core issue of this Article, which intersects the two previous parts: how income from compensatory stock rights should be taxed when those rights are transferred as part of a divorce settlement. Part IV addresses the planning issues that must be considered when stock rights are part of the marital estate. Part V sets forth recommendations for reform to reduce the unnecessary legal complexity associated with divorce-related transfers of stock rights.

I. TAXATION OF STOCK-BASED COMPENSATION GENERALLY

In general, compensatory transfers of property, such as stock, are taxed to the recipient upon grant or, if the property is not fully vested

8. Rev. Rul. 2004-60, 2004-1 C.B. 1051.

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at grant, at the time the property subsequently vests.⁹ The amount of gross income realized by the recipient of fully vested property is generally equal to the fair market value of the property at the time of the grant.¹⁰ If the property is unvested at grant, the recipient generally realizes gross income equal to the fair market value of the property at the time of vesting.¹¹ In essence, these rules provide that, for federal income tax purposes, transfers of unvested property are generally held in abeyance until the property vests, at which point the transfer is treated as occurring and subject to tax at that time.¹² However, for most compensatory stock options, special rules apply that delay the taxable event beyond vesting to the time of exercise or the sale of the underlying stock.¹³

This Part discusses the taxation of the common types of stock-based rights: restricted stock, stock options, stock appreciation rights, and phantom stock units. The discussion begins with restricted stock, which is taxed under the general rules described above.

9. See I.R.C. § 83(a) (2012). In general, unvested property is property that is subject to a substantial risk of forfeiture at the time it is granted. See Treas. Reg. § 1.83-3(b) (as amended in 2005). Most commonly, the vesting condition is the performance of services over a specified period of time. See *id.* § 1.83-3(c)(1) (providing that a “substantial risk of forfeiture exists where rights in property that are transferred are conditioned, directly or indirectly, upon the future performance . . . of substantial services”). A common arrangement for stock-based compensation is for the stock rights to vest ratably over a three-to-five year period of service. See David I. Walker, *The Non-Option: Understanding the Dearth of Discounted Employee Stock Options*, 89 B.U. L. REV. 1505, 1513 n.28 (2009).

10. The discussion above assumes that the property is granted to the service provider for no consideration other than services. If the service provider pays an amount of cash (or other property) for the granted property, then the inclusion amount is reduced by the amount paid by the service provider. See I.R.C. § 83(a).

11. If unvested property is transferred, the service provider can make an election under § 83(b) at grant; this election would cause the service provider to effectively treat the property as fully vested at grant. See *id.* § 83(b). Accordingly, if a § 83(b) election is made, the service provider must include the fair market value of the property on the date of grant. See *id.*

12. These general rules apply broadly to all sorts of compensatory property transfers, whether stock-based or not. See Treas. Reg. § 1.83-3(e) (defining “property” for § 83 purposes to include all types of real and personal property except unfunded and unsecured promises to pay money or property in the future).

13. See I.R.C. § 83(e)(3) (explaining that § 83 does not apply to the transfer of an option without a readily ascertainable fair market value); Treas. Reg. § 1.83-7(b) (as amended in 2004) (defining option with a readily ascertainable fair market value extremely narrowly); see also Ethan Yale & Gregg D. Polsky, *Reforming the Taxation of Deferred Compensation*, 85 N.C. L. REV. 571, 588 (2007) (noting that it is “extraordinarily rare” for compensatory options to be considered to have a readily ascertainable fair market value).

A. Restricted Stock

Restricted stock is stock transferred (usually without any cost or at a significant discount) to an employee that is unvested at grant.¹⁴ Restricted stock is often time-vested, meaning that it vests after a specified period of continuous employment after grant.¹⁵ Restricted stock can also be performance-vested, meaning that it vests upon the attainment of specified performance conditions, or it can be subject to a combination of time- and performance-vesting.¹⁶ If the stock does not vest, it reverts back to the employer.¹⁷ The employer has great flexibility in determining the vesting period and conditions, but restricted stock is most commonly time-vested with vesting periods between three and five years.¹⁸

Restricted stock is taxed under the traditional rules governing compensatory transfers of property¹⁹ and, thus, is generally taxable upon vesting,²⁰ with the amount of income based on the fair market value of the stock at that time.²¹ For example, if restricted stock with a value of \$10 is transferred without cost to an employee in Year 1, and the stock thereafter vests in Year 2 when it is worth \$15, the employee realizes \$15 of ordinary income in Year 2. The employee will also take a \$15 basis in the stock at the same time. The \$15 of ordinary income realized by the employee constitutes wages for employment tax purposes, so it is also subject to employment taxes.²² When the employee subsequently sells the stock, the employee will

14. MYRON S. SCHOLES ET AL., *TAXES AND BUSINESS STRATEGY* 240 (4th ed. 2009).

15. See Walker, *supra* note 9, at 1513.

16. See *id.* An example of combined time- and performance-vested restricted stock is stock that vests upon the later of (i) one year of continuous employment, and (ii) the date on which a specified level of earnings per share is attained.

17. Michael S. Knoll, *The Section 83(b) Election for Restricted Stock: A Joint Tax Perspective*, 59 SMU L. REV. 721, 722 (2006).

18. See John F. Coyle & Gregg D. Polsky, *Acqui-Hiring*, 63 DUKE L.J. 281, 297–98 & n.61 (2013) (noting that, in Silicon Valley, equity compensation typically vests “ratably on a monthly basis over three to four years” with a “one-year cliff”).

19. See I.R.C. § 83(a) (2012).

20. Restricted stock recipients can elect under § 83(b) to make the granting of restricted stock the taxable event (with the amount of compensation determined by the value of the stock at that time), see *id.* § 83(b), but this election is typically only made when the restricted stock is purchased by the employee at, or very close to, fair market value, such that the compensatory aspect of the transaction is minimal.

21. If the restricted stock were granted for free, then the employee would include the full value in gross income; if the restricted stock were 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 were to vest, then there would be no tax consequences.

22. See Rev. Rul. 79-305, 1979-2 C.B. 350.

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realize capital gain or capital loss to the extent of the difference between the sales price and this \$15 basis.²³

B. Stock Options

Another common form of stock-based compensation is stock options, which represent the right to purchase a share of stock at a predetermined price (referred to as the “strike price”) during a specified period.²⁴ Compensatory stock options usually become exercisable (“vest”) only after a specified period of employment.²⁵ Stock options typically have a strike price equal to the fair market value of the underlying stock at the time of grant,²⁶ vest ratably over a three-to-five year period, and expire ten years after grant.²⁷

Under the general rules governing the taxation of compensatory transfers of property, options would be taxable upon grant or, if the options are invested at grant, upon subsequent vesting.²⁸ However, because of the perceived difficulty in valuing stock options before they are exercised,²⁹ a special tax regime applies to them.³⁰

To determine the tax consequences stemming from compensatory stock options, the options must first be classified as either incentive stock options (“ISOs”) or nonqualified stock options (“NQSOs”).³¹ In order to qualify as an ISO, stock options must meet all of the criteria listed in I.R.C. § 422(b).³² One criterion is that the

23. Any capital gain would not be subject to employment taxes because it would not be characterized as either wages or self-employment income; however, I.R.C. § 1411’s net investment income tax might apply to it. *See* I.R.C. § 1411(c).

24. SCHOLES ET AL., *supra* note 14, at 245.

25. Stock options can also be performance-vested or be subject to a combination of performance and time vesting. *See supra* note 16 and accompanying text.

26. Since the 2004 enactment of I.R.C. § 409A, which generally taxes stock options with a strike price below fair market value at the time of grant harshly, in-the-money options are exceedingly rare. *See Walker, supra* note 9, at 1508–09, 1514.

27. *See Coyle & Polsky, supra* note 18, at 297–98 & n.61. There may be “cliff” vesting for the first batch of options, such that all of the Year 1 will vest on the first anniversary, with the remaining options vesting monthly on a ratable basis over the remaining vesting period.

28. *See* I.R.C. § 83(a).

29. *See* 3 BORIS I. BITTKER & LAWRENCE LOKKEN, *FEDERAL TAXATION OF INCOME, ESTATES AND GIFTS* ¶ 60.5.2 (3d ed. 2001) (explaining that the difficulty in valuation of options is the justification for the special tax treatment of options).

30. *See* I.R.C. § 83(e)(3) (taxing compensatory stock options without a readily ascertainable fair market value when the options are exercised, rather than when they are granted or when they vest); Treas. Reg. § 1.83-7 (as amended in 2004) (same).

31. *See Walker, supra* note 9, at 1508 n.8.

32. *See* I.R.C. § 422(b). There are numerous conditions to ISO treatment in § 422, but the most significant are: (i) the option must be granted pursuant to a stock-option plan approved by shareholders within twelve months of the date of adoption of the plan by the

terms of the option must not designate the option as *not* an ISO.³³ As described below, the tax treatment of ISOs is often disadvantageous for employers;³⁴ therefore, many employers explicitly designate their options as non-ISOs.³⁵ Any compensatory stock options that are not ISOs, whether because of an explicit designation or because they do not meet the substantive criteria, are characterized as NQSOs.

1. Taxation of NQSOs

Except in highly unusual circumstances,³⁶ there are no tax consequences to either the employer or the employee upon grant or vesting of NQSOs.³⁷ In general, upon the *exercise* of a NQSO, the employee recognizes compensation income equal to the difference between the fair market value of the underlying stock on the date of

board of directors; (ii) the option, by its terms, must not be transferable by the employee except by will or the laws of descent and distribution; and (iii) the number of ISOs that first become exercisable during a taxable year is limited under § 422(d). *See id.* § 422(b), (d).

33. *See id.* § 422(b) (“Such term [incentive stock option] shall not include any option if (as of the time the option is granted) the terms of such provide that it will not be treated as an incentive stock option.”).

34. *See infra* Part I.B.2.

35. *See* Scott Jaquette, Matthew Knittel, & Karl Russo, *Recent Trends in Stock Options* 4–5 & n.6 (U.S. Dep’t of the Treasury, Office of Tax Analysts, OTA Working Paper 89, 2003), available at <http://www.treasury.gov/resource-center/tax-policy/tax-analysis/Documents/ota89.pdf> (estimating that approximately 90% of the options issued in the late 1990s and early 2000s were NQSOs).

36. If a compensatory stock option is considered to have a readily ascertainable fair market value upon grant, then there would be tax consequences upon grant or, if the option is unvested at the time of grant, upon vesting of the option. In order for a compensatory option to be considered to have a readily ascertainable fair market value upon grant, either the option must be actively traded on an established market or all of the following conditions must be satisfied at the time of grant:

- (i) The option is transferable by the [employee];
- (ii) [t]he option is exercisable immediately in full by the [employee];
- (iii) [t]he option or [the stock underlying the option must not be] subject to any restriction or condition (other than a lien or other condition to secure the payment of the [exercise] price) which has a significant effect upon the fair market value of the option; and
- (iv) [t]he fair market value of the option privilege is readily ascertainable

Treas. Reg. § 1.83-7(b) (as amended in 2004). As mentioned above, it would be extremely unusual for a compensatory option to be characterized as having a readily ascertainable fair market value at the time of grant under these rules. *See supra* note 30 and accompanying text.

37. *See* Treas. Reg. § 1.83-7(a) (providing that, when an option lacking a readily ascertainable fair market value is granted, the transfer of stock pursuant to the option exercise is subject to I.R.C. § 83(a)).

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exercise and the option's strike price (the "spread"),³⁸ and the employer receives a corresponding deduction in the same amount.³⁹ The employee's income is characterized as ordinary income for federal income tax purposes and as wages for federal employment tax purposes.⁴⁰ The employee's basis in the shares received pursuant to the option exercise is the fair market value of the underlying stock at the time of exercise, increased by any transaction costs (such as broker's fees) incurred in connection with the exercise. Therefore, if, as is commonly done, the employee sells the underlying stock immediately after exercise in a "cashless exercise,"⁴¹ the employee will recognize ordinary income on the spread as well as a very small short-term capital loss equal to the transaction costs incurred in connection with the sale of the underlying stock.

2. Taxation of ISOs

Turning now to ISOs, there are also no tax consequences to anyone upon the grant or vesting of these options.⁴² The tax consequences upon exercise of an ISO and the sale of the underlying stock depend on whether the ISO holding-period condition is satisfied.⁴³ To satisfy this condition, after exercise of the ISO, the employee must not dispose of the underlying stock before the later of (i) two years from the date of the grant of the ISO or (ii) one year from the date of the exercise of the ISO.⁴⁴ If this holding-period condition is satisfied, then the employee does not recognize any income upon *exercise* of the option.⁴⁵ Instead, the employee recognizes long-term capital gain (or loss) only upon the *sale* of the underlying stock.⁴⁶ The capital gain (or loss) is equal to the difference between the exercise price of the ISO and the sales proceeds from the

38. *See id.* (providing that I.R.C. § 83(a) applies upon the option's exercise); *see also* I.R.C. § 83(a) (taxing compensatory property transfers to the extent that the value of the property exceeds the amount paid for the property).

39. *See* Treas. Reg. § 1.83-6(a) (as amended in 2003) (stating that a corresponding deduction to the employer is allowable under I.R.C. § 162).

40. *See* Treas. Reg. § 1.83-1(a)(1) (1978) (stating that income inclusion under I.R.C. § 83 is characterized as compensation).

41. In a cashless exercise, the employer delivers to the employee a cash amount representing the spread between the strike price and the fair market value of the stock at the time of exercise (reduced by applicable tax withholding).

42. *See* I.R.C. § 421(a)(1).

43. *See id.* § 421(a)(1), (b).

44. *See id.* § 422(a).

45. *See id.* § 421(a). The exclusion of gain upon the exercise of ISOs is a preference item for alternative minimum tax ("AMT") purposes and, accordingly, can result in additional tax in the year of exercise by virtue of the AMT. *See id.* § 56(b)(3).

46. *Id.* § 421(a).

stock sale.⁴⁷ In addition, if the ISO holding-period condition is satisfied, the employer does not receive any deduction at any time with respect to the ISO.⁴⁸

If the ISO holding-period condition is *not* satisfied, because the holder makes a premature “disqualifying disposition” of the underlying stock, the tax consequences are consistent with those that result from NQSOs.⁴⁹ The employee would recognize the spread between the exercise price and the fair market value of the underlying stock (as of the date of exercise) as compensation income, and any post-exercise appreciation or depreciation would be characterized as capital gain or loss.⁵⁰ And, as in the context of NQSOs, the employer would receive a compensation deduction equal to the spread.⁵¹

The tax benefits to the employee of ISO treatment are deferral and character conversion. If the holding-period condition is satisfied, instead of recognizing compensation income immediately upon exercise of the option, the holder recognizes capital gain only upon the subsequent sale of the underlying stock. However, the cost to the employer of ISO treatment (if the holding-period condition is satisfied) is that the employer relinquishes its entire deduction upon the employee’s exercise of the option. For employers without substantial net operating losses, the cost of losing this deduction typically exceeds the tax benefits realized by the employee, which makes the ISO instrument tax-inefficient.⁵² This inefficiency explains why NQSOs remain far more popular than ISOs.⁵³

47. *Cf. id.* § 421(a)(1) (providing that the exercise of an ISO is not a taxable event, therefore implying that the ultimate transfer of the underlying stock is the appropriate taxable event).

48. *See id.* § 421(a)(2).

49. *See id.* § 421(b); Treas. Reg. § 1.421-2(b)(1)(i) (as amended in 2004).

50. *See* Treas. Reg. § 1.421-2(b)(1)(i).

51. *See id.* If a disqualifying disposition occurs in a taxable year after the taxable year in which the option was exercised, the employee’s ordinary income and the employer’s compensation deduction would be realized in the year of the disposition, not in the earlier year of exercise. *See* I.R.C. § 421(b). In such a case, while the amount of ordinary income, compensation deduction, and capital gain or loss will be the same as if the ISO was a NQSO, the timing will be slightly different. On the other hand, if the disqualifying disposition occurs in the same year as the exercise (as in the case of a cashless exercise), the tax consequences would be identical to those that would result if the ISO had been a NQSO.

52. *See* Jeffrey M. Colón, *Double Dipping: The Cross-Border Taxation of Stock Options*, 35 RUTGERS L.J. 171, 194–95 (2003) (explaining that ISOs are generally tax inefficient relative to NQSOs).

53. *See* Jaquette, Knittel, & Russo, *supra* note 35, at 5 n.6.

C. Synthetic Stock-Based Rights: SARs and PSUs

When stock options are exercised or restricted stock is issued, the number of outstanding shares increases unless an equivalent amount of shares is simultaneously redeemed. To prevent dilution of existing shareholders, employers sometimes create synthetic instruments that replicate the economics of stock options or restricted stock without increasing the number of shares outstanding.⁵⁴ Stock appreciation rights (“SARs”) are contractual rights that are analogous to stock options.⁵⁵ SARs give the holder the right to be paid in cash an amount equal to the spread between a specified price, usually the fair market value of the employer’s shares at the time of grant, and the value of the employer’s shares on any date chosen by the employee, subject to the usual vesting conditions.⁵⁶ Phantom stock units (“PSUs”) mimic restricted stock shares and give the employee the right to be paid in cash in an amount equal to the value of the referenced shares on a specified future date, usually on or shortly after the vesting date.⁵⁷

When restricted stock or stock options are actually issued, the employee is treated as receiving property for tax purposes.⁵⁸ On the other hand, SARs and PSUs are not considered property; instead, they are treated as mere promises to pay money in the future.⁵⁹ As mere promises to pay, they are disregarded for tax purposes under the cash method of accounting used by individuals.⁶⁰ When the cash is ultimately paid, the cash payment is simply taxed as compensation income (i.e., subject to income tax as ordinary income and to employment taxes as wages). The employer receives a corresponding deduction at the same time.⁶¹

54. See Stuart R. Cohn, *Stock Appreciation Rights and the SEC: A Case of Questionable Rulemaking*, 79 COLUM. L. REV. 66, 81 (1979).

55. See *id.* at 70–71; Walker, *supra* note 9, at 1512.

56. See Cohn, *supra* note 54, at 70–71.

57. See Walker, *supra* note 9, at 1513.

58. See Treas. Reg. § 1.83-3(e) (as amended in 2005) (defining, for I.R.C. § 83 purposes, “property” to mean all “real and personal property other than either money or an unfunded and unsecured promise to pay money or property in the future”).

59. *Id.* (excluding “unfunded and unsecured promise[s] to pay money or property in the future” from the definition of property for I.R.C. § 83 purposes).

60. See Gregg D. Polsky & Brant J. Hellwig, *Taxing the Promise to Pay*, 89 Minn. L. Rev. 1092, 1111–13 (2005) (explaining that, under the cash method of accounting, mere promises to pay are disregarded until ultimate payment is received).

61. See I.R.C. § 404(a)(5) (2012) (providing that deductions attributable to nonqualified deferred compensation are allowed in the taxable year in which the employee must include the income).

D. Summary

A common theme in the tax treatment of the above-described stock rights, which is key to the topic of this Article, is tax deferral. The employee earns stock rights through the performance of services over a period of time, usually over multiple taxable years. Yet, the taxable event occurs only at the very end of that service period or after it. The taxation of restricted stock is deferred until the very end of the service period, while the taxation of stock options is deferred until the exercise (in the case of NQSOs) or sale of the underlying stock (in the case of ISOs), and the taxation of SARs and PSUs until cash payment.⁶²

The taxation of compensatory stock-based rights is summarized in the following table:

Type of Stock Right	Taxable Event	Character of Income	Employer's Consequence
Restricted Stock	Vesting of stock	Ordinary/Wages	Deduction upon vesting
NQSO	Exercise of option	Ordinary/Wages	Deduction upon exercise
ISO (if holding period satisfied ⁶³)	Sale of underlying stock	Capital Gain/Not Wages	No deduction at any time
SAR	Receipt of cash	Ordinary/Wages	Deduction upon payment of cash
PSU	Receipt of cash	Ordinary/Wages	Deduction upon payment of cash

Tax deferral allows for the possibility that stock-based rights could be transferred in an equitable distribution before the taxable event. Such a “midstream” transfer raises the tax issue of who will report the income from those rights: the employee spouse who has earned or will earn the entitlement to those rights or the nonemployee spouse who will ultimately receive the cash benefits from those rights? This question is addressed below in Part III.

62. *See supra* Part I.

63. If the holding period is not satisfied, then the tax consequences of ISOs are generally the same as NQSOs. *See* I.R.C. § 421(b).

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However, before focusing on transfers of stock rights, one must understand the general framework for taxing divorce settlements, which is the subject of the next part. Part II first discusses I.R.C. § 1041, which generally governs transfers of property between spouses in divorce and provides that neither party is taxed on the transfer. Part II then examines the common law assignment of income doctrine, which taxes certain transferors on income generated by property that has been transferred to another party, whether or not in the context of divorce. This doctrine is relevant to transfers of stock rights because the taxable event (e.g., vesting of restricted stock) may occur after the stock right has been transferred, potentially causing the transferor to be taxed on income received by the transferee. Finally, Part II discusses how § 1041 and the assignment of income doctrine interrelate when unvested property is transferred as part of a divorce settlement. As described below, the Ninth Circuit has held that when unvested property rights are transferred in a divorce, the assignment of income effectively trumps § 1041, resulting in the transferor spouse being taxed on income generated by the property after the transfer. Part III will then relate these concepts to stock-based compensation transferred in divorce.

II. SECTION 1041 AND THE ASSIGNMENT OF INCOME DOCTRINE

Section 1041 provides that divorce-related transfers of property have no immediate tax consequences (i.e., neither the transferor nor the transferee is taxed on the transfer) and that the transferee spouse receives the property with a carryover basis from the transferor spouse.⁶⁴ Congress enacted this rule to “make the tax laws as unintrusive as possible with respect to relations between spouses.”⁶⁵ Section 1041 unquestionably applies to nearly all kinds of property commonly transferred in a divorce, such as houses, cars, jewelry, and assets held for investment, such as stocks, bonds, and real estate.⁶⁶

However, the application of § 1041 to transfers of compensatory stock rights is not straightforward because of the section’s theoretical conflict with the common law assignment of income doctrine. That doctrine, which provides that compensation is always taxable to the person who earned it, is intended to prevent taxpayers from

64. I.R.C. § 1041(b).

65. H.R. REP. NO. 98-432, pt. 2, at 1492 (1984), *reprinted in* 1984 U.S.C.C.A.N. 1131, 1135.

66. *See* Treas. Reg. § 1.1041-1T(a), Q&A (4) (as amended in 2003) (providing that “transfers of property (whether real or personal, tangible or intangible) are governed by section 1041”).

deflecting income onto others through transfers.⁶⁷ For example, in the famous assignment of income case *Lucas v. Earl*,⁶⁸ the Supreme Court held that a husband was taxable on all of the compensation in respect of his personal services, even though he had previously contracted to give half of all such compensation to his wife.⁶⁹ The Court explained that the “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.”⁷⁰ As a policy matter, the assignment of income doctrine makes sense because a contrary rule would allow easy income shifting from higher-bracket donors to lower-bracket donees; this would undermine the tax law’s progressive rate structure.⁷¹

The conflict between § 1041 and the assignment of income doctrine in the context of compensatory stock rights stems from the fact that the employee spouse performs the personal services that give rise to the stock rights and cause them to vest, while the nonemployee spouse may hold those rights when the normal taxable event (e.g., the exercise of an option) occurs. If § 1041 controls, then the nonemployee spouse, who took a carryover basis in the stock rights at the time of transfer, should report the income from the later taxable event. If the assignment of income doctrine controls, then the employee spouse should report the income notwithstanding the fact that the nonemployee spouse now holds the relevant property.⁷²

The leading case on the conflict between § 1041 and the assignment of income doctrine is *Kochansky v. Commissioner*,⁷³ a

67. See Brant J. Hellwig, *The Supreme Court’s Casual Use of the Assignment of Income Doctrine*, 2006 U. ILL. L. REV. 751, 766–75 (explaining the scope and purpose of the doctrine).

68. 281 U.S. 111 (1930).

69. *Id.* at 114–15.

70. *Id.* at 115.

71. See Hellwig, *supra* note 67, at 769–70 & n.107.

72. It is possible that the application of the assignment of income doctrine could also accelerate the timing of the taxable event. For example, if the employee spouse transfers NQSOs on the date of divorce, it is possible that the employee spouse could realize income on that date (to the extent of the fair market value of the option at the time), even though had the employee spouse held onto those options, no tax would be due until exercise. See, e.g., I.R.S. Field Serv. Advice Mem. 200005006, at 2 (Feb. 4, 2000) [hereinafter FSA], available at <http://www.irs.gov/pub/irs-wd/0005006.pdf> (concluding that the employee spouse realizes compensation income on the date of the transfer of stock options to the extent of the spread, while the nonemployee spouse realizes capital gain or loss when the option or underlying stock was sold or when the option expired). However, as discussed below, the IRS reversed its position in this field service advice when it subsequently issued Revenue Ruling 2002-22, 2002-1 C.B. 849.

73. 92 F.3d 957 (9th Cir. 1996).

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1996 Ninth Circuit decision. In that case, the taxpayer, a plaintiff's lawyer, had entered into a contingent fee agreement with a client in a medical malpractice case.⁷⁴ During the course of the malpractice case, the taxpayer divorced and, in connection with the divorce, transferred a one-half interest in his contingent fee rights to his former spouse.⁷⁵ The malpractice case eventually settled, and the former spouse received half of the contingent fee.⁷⁶ The issue was whether the taxpayer was taxable on the entire fee or only the one-half portion that he had retained.⁷⁷ Citing *Lucas v. Earl* 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 taxpayer.⁷⁸

While *Kochansky* suggests that the assignment of income doctrine trumps § 1041 when the two are in conflict, doubts have remained. In the aftermath of that case, some commentators harshly criticized the decision on both technical and policy grounds.⁷⁹ In addition, because *Kochansky* involved only the transfer of “unvested” rights—i.e., an interest in a contingency fee with respect to which the taxpayer had to continue to perform services before it matured—its rule might not apply to transfers of rights that have already vested before divorce.

Consider, for example, a transfer of stock options that vested before they were transferred in a divorce. Would the holding in *Kochansky* that the transferor is taxed upon the eventual taxable event (i.e., exercise) apply equally in this context? It is not entirely clear that it would. In *Kochansky*, the taxpayer performed some services after the marriage that were necessary to cause the contingent fee rights to “vest,”⁸⁰ so arguably it makes sense to tax the

74. *Id.* at 958.

75. *Id.*

76. *Id.*

77. *See id.*

78. *Id.* at 959. Accordingly, the taxpayer's spouse was deemed to receive the cash representing one half of the contingent fee in a tax-free I.R.C. § 1041 transaction.

79. *See* Deborah H. Geier, *Simplifying and Rationalizing the Federal Income Tax Law Applicable to Transfers in Divorce*, 55 TAX LAW. 363, 448–50 (2002) (arguing that the assignment of income doctrine is irrelevant to *Kochansky* and that the court's approach created unnecessary confusion); Sarah Dods, Note and Comment, *Kochansky v. Commissioner: The Assignment of Income Doctrine, Community Property Law, and I.R.C. § 1041*, 72 WASH. L. REV. 873, 873 (1997) (arguing that § 1041, rather than the assignment of income doctrine, should have applied in *Kochansky*).

80. In a contingent fee agreement, the lawyer generally must continue to work on the case until it is favorably resolved in order to become entitled to the contingent fee. *See, e.g., Potts v. Mitchell*, 410 F. Supp. 1278, 1282 (W.D.N.C. 1976) (holding that an attorney's interest in a claim “could not become ‘vested’ in a contingent fee situation until the case

taxpayer on the fruits of those personal, post-marital services.⁸¹ And, because it can be exceedingly difficult to determine the value of the pre-divorce services relative to the post-marital services, a rough justice approach of simply taxing the service-providing spouse on the entire amount could be justified. On the other hand, when fully vested rights (such as vested stock options) are transferred, all of the relevant services were performed while the marital unit (which was the taxpaying unit at that time) still existed. In theory, the fruits of those services should be taxed to the marital unit, but that is no longer feasible once the marital unit has dissolved. Given the infeasibility, a second-best option seems to be to tax one of the former spouses in his or her individual capacity.⁸² In such a case, it is not clear why taxing the employee spouse is any better of a rough-justice approach than taxing the nonemployee spouse. For this reason, the *Kochansky* approach is not necessarily appropriate for transfers of fully vested rights.

Because of the conflict between § 1041 and the assignment of income doctrine, as well as the critiques and uncertainties of *Kochansky*, the taxation of stock-based rights transferred in divorce was for many years quite muddled. As discussed in the next Part,

was prosecuted to a favorable judgment or settled by the contracting attorney”); *see also* *Hardison v. Weinschel*, 450 F. Supp. 721, 723 (E.D. Wis. 1978) (finding an attorney’s withdrawal from a case to be a forfeiture of his contingency fee); *Gary v. Cohen*, 231 N.Y.S.2d 394, 398 (N.Y. Sup. Ct. 1962) (stating that “if an attorney is justifiably discharged, he is not entitled to recover compensation from his client”); *Royden v. Ardoin*, 331 S.W.2d 206, 209 (Tex. 1960) (standing for the proposition that, if an attorney voluntarily quits the case or is discharged by the client for cause, then the attorney generally is entitled to no fee).

81. In *Kochansky*, the court found that the taxpayer transferred “only the right to receive the income” (i.e., the “fruits”) rather than income-producing property (the “tree”). *See* 92 F.3d at 959. Accordingly, he remained subject to tax on the income from the contingent fee arrangement under the assignment of income doctrine. *Id.* Important to the court’s analysis was the fact that *Kochansky* “continued to render and control the personal services that produced the fee.” *Id.* In contrast, in *Meisner v. United States*, 133 F.3d 654 (8th Cir. 1998), the Eighth Circuit found that the *transferee* spouse was taxable on income produced by royalty rights that were transferred in a divorce. *See id.* at 657. The court reasoned that the assignment of income doctrine did not apply because the transferor spouse had transferred “an income-producing asset” (the “tree”) to the transferee. *Id.* at 656. In that case, the transferor provided no ongoing services that produced the royalties and retained no control over the transferred rights. *Id.* at 657. Arguably, the transfer of vested stock rights may be more like the situation in *Meisner*, while the transfer of certain unvested stock rights may be more analogous to *Kochansky*. For further discussion, see *infra* Part III.B.

82. Another approach would be to accelerate the taxable event but, as discussed below, that would raise significant administrative burdens and therefore would not be a workable approach.

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recent developments have substantially clarified matters in some respects, though some uncertainties still remain.

III. TRANSFERS OF STOCK-BASED RIGHTS IN DIVORCE: THE CURRENT STATE OF THE LAW

This Part discusses the current state of the law regarding divorce-related transfers of compensatory stock-based rights. In 2002, the IRS issued a revenue ruling clarifying that § 1041 trumps the assignment of income doctrine, at least with regard to stock rights that are fully vested prior to transfer.⁸³ However, the tax treatment of transfers of unvested rights remains ambiguous.

Section A of this Part discusses the IRS's approach to transfers of stock rights in divorce before the issuance of Revenue Ruling 2002-22. In earlier private guidance, the IRS took the position that the assignment of income doctrine applied to transfers of NQSOs and that the *transferor* was therefore taxable on such transfers at the time of the transfer. As discussed in Section B, the IRS retreated from this position—at least with respect to transfers of vested options—in Revenue Ruling 2002-22, in which the IRS ruled that the *transferee* was taxable upon exercise pursuant to § 1041. The IRS did not rule on the proper treatment of transfers of unvested stock rights, leaving the law unclear in this area. Section C then discusses additional guidance issued by the IRS on the employment tax consequences of transferring vested stock rights in divorce, which provides that the employee spouse bears the nominal burden of such taxes even though the transferee bears the income tax burden.

A. *Pre-2002 Treatment of Transfers of Stock Rights in Divorce*

Prior to 2002, the IRS took the position that the assignment of income doctrine applied to divorce-related transfers of compensatory stock-based rights.⁸⁴ In a 2000 Field Service Advice (“FSA”),⁸⁵ a husband transferred NQSOs to his wife in connection with their divorce, and his wife subsequently exercised the options.⁸⁶ The FSA

83. See Rev. Rul. 2002-22, 2002-1 C.B. 849.

84. See FSA, *supra* note 72, at 6.

85. *Id.* at 1. A FSA is case-specific advice that is provided by the IRS Office of Chief Counsel to revenue agents in the field.

86. In the FSA, the husband transferred both ISOs and NQSOs. However, because one of the conditions to ISO status is nontransferability, the FSA determined that the transfer caused the ISOs to be recharacterized as NQSOs. This particular conclusion of the FSA was subsequently confirmed in Revenue Ruling 2002-22, 2002-1 C.B. 849. Because the ISOs immediately morphed into NQSOs, the taxation of all of the transferred

analyzed the tax consequences of the transfer and the subsequent exercise and concluded that, notwithstanding § 1041, the husband recognized ordinary income when the options were *transferred*, not at the time of exercise,⁸⁷ which is the traditional taxable event for NQSOs.⁸⁸ The amount of income realized by the transferor was the fair market value of the options at the time of transfer.⁸⁹ The FSA explained that, when in conflict, the assignment of income doctrine trumps § 1041.⁹⁰

The lifespan of the FSA was not long, as it was quickly superseded by a 2002 Revenue Ruling.⁹¹ Nevertheless, several aspects of the FSA are worth noting. First, the FSA did not indicate whether the options were vested or unvested at the time of transfer, even though the 2002 Revenue Ruling subsequently drew a significant distinction along that line.⁹² Perhaps, because the FSA did not draw any distinctions between vested and unvested options, its conclusion would have been the same in either case, but this is certainly debatable.⁹³

Second, in addition to taxing the husband-transferor, the FSA also accelerated the taxable event, which is something that *Kochansky* did not do. Had the husband retained and exercised the options, he would not have been taxed until exercise.⁹⁴ The FSA determined the taxable event to be the transfer of the options, which, by definition, must occur before exercise.⁹⁵ However, the assignment of income doctrine is generally understood to affect merely the attribution of income, not the timing of income realization.⁹⁶ Yet, in

options was identical, and the discussion above disregards the irrelevant temporary ISO status.

87. FSA, *supra* note 72, at 2.

88. *See supra* Part I.B.1.

89. FSA, *supra* note 72, at 2.

90. *Id.* at 5–6.

91. Rev. Rul. 2002-22, 2002-1 C.B. 849.

92. *Compare id.* (drawing a distinction between vested and unvested options), with FSA, *supra* note 72, at 2 (leaving unresolved the significance of whether an option was vested or unvested).

93. Under the facts of the FSA, the options ultimately were exercised, so if they were unvested at the time of transfer, they subsequently did in fact vest. *See* FSA, *supra* note 72, at 2.

94. As explained above in *supra* note 86, the transferor transferred both ISOs and NQSOs, though the transfer caused the ISOs to immediately morph into NQSOs. Had the transferor retained the ISOs, the taxable event would have been delayed until the sale of the underlying stock.

95. If the transfer occurred post-exercise, then the transferor would have been transferring stock, not options.

96. *See, e.g., Helvering v. Eubank*, 311 U.S. 122, 124–25 (1940) (holding that, when an insurance salesman gratuitously transferred the rights to future renewal commissions, the

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this case, the FSA determined that the assignment of income doctrine not only caused the husband to be taxed with respect to the options, but it also accelerated the husband's income realization.⁹⁷

Third, the FSA's approach created some significant administrative complexity. The FSA concluded that, upon the transfer, the husband was taxed on the fair market value of the options, not on the spread between the value of the underlying stock and the exercise price of the options.⁹⁸ Because there is value in the option privilege, which is "the opportunity to benefit during the option's exercise period from any increase in the value of property subject to the option during such period, without risking any capital," the fair market value will always exceed the spread to some extent.⁹⁹ However, determining the value of the option privilege is often difficult, and this valuation difficulty is precisely what justifies the unique wait-and-see approach to taxing compensatory stock options.¹⁰⁰ Under the FSA's approach, options must be prematurely valued when they are transferred in a divorce.

In addition to creating valuation issues, the FSA's approach doubles the number of taxable events. If options are not transferred in connection with a divorce, the exercise of an option is the single taxable event in the typical situation where options are cashlessly exercised.¹⁰¹ In the FSA, the husband's transfer constituted a taxable event, and the husband's gross income amount became the wife's adjusted basis in the option.¹⁰² When the wife subsequently exercised the option, the exercise price was added to that adjusted basis, and when the wife thereafter sold the underlying stock, she would recognize gain or loss to the extent her amount realized exceeded that

salesman was taxed on those commissions under the assignment of income doctrine at the time the commissions were received by the donee); *see also* MARVIN A. CHIRELSTEIN & LAWRENCE ZELENAK, *FEDERAL INCOME TAXATION* ¶ 8.02, at 254 (12th ed. 2012) (explaining that the timing of tax in *Eubank* was correct because if the assignment of the rights "produced income to the taxpayer—that would be a rule of realization rather than one of mere attribution").

97. FSA, *supra* note 72, at 4–5.

98. *Id.* at 5.

99. Treas. Reg. § 1.83-7(b)(3) (as amended in 2004).

100. *See* BITTKER & LOKKEN, *supra* note 29, ¶ 60.5.2. As discussed above, the general rule for compensatory property transfers is that they are taxed at either transfer or vesting, while NQSOs are generally taxed only upon exercise.

101. *See* SCHOLES ET AL., *supra* note 14, at 254 n.19 (estimating that 75% of NQSO exercises are followed by the immediate sale of the underlying stock). Even in a cashless exercise, the immediate sale is a second taxable event, but as explained above, this will result in a *de minimis* short-term capital loss equal to the amount of transaction costs incurred in exercising the option and selling the underlying stock.

102. FSA, *supra* note 72, at 2.

adjusted basis.¹⁰³ Thus, under the FSA, there was a taxable event for the husband when he transferred the option, and there would be a second taxable event for the wife when she eventually sold the underlying stock.

Finally, the FSA's approach placed potentially onerous reporting burdens on employers. When the husband transferred the option, he realized compensation income to the extent of the fair market value of the option. This means that the employer would have to report that value as wages and make the necessary withholding at that time, and these burdens were the result of unilateral action taken by the employee.¹⁰⁴

B. Treatment of Transfers of Stock Rights in Divorce Under Revenue Ruling 2002-22

Perhaps because of these administrative issues created by the approach in the 2000 FSA, the IRS quickly reversed course in Revenue Ruling 2002-22.¹⁰⁵ The ruling described the same basic facts as in the FSA: a transfer of NQSOs incident to a divorce, followed by the nonemployee spouse exercising those options.¹⁰⁶ The ruling, however, reached a completely different conclusion, holding that § 1041 applied to the transfer.¹⁰⁷ As a result, the transferor did not realize any income, the transferee took a carryover (i.e., zero) basis in the options, and the transferee was taxed upon exercise.¹⁰⁸ The

103. Because the option would not be a compensatory option in the wife's hands, it would no longer be subject to the tax rules governing these types of options. Instead, the tax rules governing purchased options would apply. Those rules effectively tax options on an open transaction method, under which the holder does not recognize gain or loss until the underlying stock is ultimately sold (if the option is exercised) or until the option is sold or expires unexercised. *See* Rev. Rul. 78-182, 1978-1 C.B. 265.

104. *See* Treas. Reg. § 31.3401(a)-1(a)(4) (as amended in 2006) (stating that noncash remuneration is generally subject to withholding).

105. Rev. Rul. 2002-22, 2002-1 C.B. 849. While field service advice is nonbinding and does not represent an official position of the IRS, a revenue ruling is an official interpretation of the law by the IRS. *See* Mitchell Rogovin & Donald L. Korb, *The Four R's Revisited: Regulations, Rulings, Reliance, and Retroactivity in the 21st Century: A View From Within*, 46 DUQ. L. REV. 323, 330-31, 356-57 (2008). Thus, Revenue Ruling 2002-22 effectively overrules FSA 200005006.

106. The fact pattern in the ruling did not involve ISOs, but the ruling confirmed that ISOs transferred in a divorce automatically convert into NQSOs, so the analysis would have been the same had ISOs been involved.

107. Rev. Rul. 2002-22, 2002-1 C.B. 849.

108. Upon exercise, the transferee would realize ordinary income in an amount equal to the spread between the fair market value of the underlying stock (at the time of exercise) and the exercise price, which is the same tax consequence that would have occurred had the transferor retained and exercised the option.

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transferee effectively stepped into the transferor's shoes with respect to the option.

1. Transfers of Vested Stock Rights

The NQSOs at issue in Revenue Ruling 2002-22 were vested at the time of transfer. The ruling essentially clarified that § 1041 applies to transfers of *vested* stock options in divorce. Accordingly, in contrast to the approach taken by the IRS in the 2000 FSA, the transferor realized no tax consequences with respect to the transferred options.¹⁰⁹ Additionally, the taxable event was not accelerated but instead occurred at the time that the options were exercised.¹¹⁰ This approach is much simpler than the FSA approach, as it obviates the need for any premature valuation of the options and limits the number of taxable events to one. And as discussed above in Part II, this approach is not necessarily inconsistent with *Kochansky*, because that case involved a transfer of *unvested* property rights in a divorce.

2. Transfers of Unvested Stock Rights

While Revenue Ruling 2002-22 clarified the treatment of vested options (and, by analogy, vested SARs), it carved out unvested rights from its scope, noting:

This ruling also 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.¹¹¹

This carve-out applies to unvested NQSOs, which are specifically mentioned, and to unvested SARs and unvested phantom stock arrangements, because these constitute unfunded, deferred compensation rights that are unvested at the time of transfer. The carve-out also applies to restricted stock because these are "future income rights" that are "unvested at the time of transfer."¹¹²

109. See Rev. Rul. 2002-22, 2002-1 C.B. 849.

110. *Id.*

111. *Id.* (citing *Kochansky v. Comm'r*, 92 F.3d 957 (9th Cir. 1996)).

112. If the restricted stock has vested before the transfer, then it is no longer restricted stock at the time of transfer and § 1041 clearly would apply. Of course, the vesting would, absent an I.R.C. § 83(b) election, have been a taxable event for the transferor. If a § 83(b) election had been made, then the restricted stock is treated as unrestricted stock for

The ruling's citation to the *Kochansky* case seems to indicate that *Kochansky* would apply when these unvested rights are transferred in connection with a divorce. The transfer of unvested rights is analogous to the fact pattern in *Kochansky*, where the contingent fee lawyer transferred half of his "unvested" contingent fee rights to his spouse, who later collected half of the fee when the case was settled.¹¹³ The Ninth Circuit held that the transferor spouse, not the transferee spouse, was liable for the tax on the transferee spouse's share (as well as his own share).¹¹⁴ The citation to *Kochansky* therefore suggests that the *transferor* of unvested stock rights is taxed when the normal taxable event occurs (i.e., upon the vesting of restricted stock, the exercise of NQSOs, or the cash settlement of SARs and PSUs).

The analogy to *Kochansky* is particularly apt with respect to restricted stock, as well as PSUs that are immediately settled upon vesting. The lawyer in *Kochansky* had to work on the case until it was successfully resolved before he became entitled to the contingent fee,¹¹⁵ and the taxable event (i.e., the receipt of the fee) occurred quickly thereafter.¹¹⁶ Likewise, holders of restricted stock and settled-upon-vesting PSUs must work for the employer until the vesting date before the rights vest; the taxable event therefore occurs simultaneously with vesting.

The analogy to *Kochansky* is less apt in other cases because the taxable event does not necessarily occur simultaneously with vesting; in fact, the taxable event could occur many years after vesting. For instance, consider a NQSO with a one-year vesting period that is transferred one day prior to vesting. If the option is exercised nine years after the transfer, the situation looks a lot different than *Kochansky*. Because the taxable event occurred nine years after vesting, much of the value of the option could be attributable not to the transferor's personal services, but rather to the transferee's investment decision to delay exercising the option for nine years. On the other hand, in *Kochansky*, the entirety of the contingent fee was attributable to the husband's work effort because payment was made immediately upon "vesting" of the contingent fee.¹¹⁷

federal income tax purposes, and § 1041 should therefore apply to the transfer of such stock.

113. See *Kochansky v. Comm'r*, 92 F.3d 957, 958 (9th Cir. 1996).

114. *Id.* at 959.

115. See cases cited *supra* note 80.

116. *Kochansky*, 92 F.3d at 959.

117. *Id.*

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This discussion suggests that, in cases where vesting and the taxable event do not occur in short order, the resulting income might be split between the transferor and the transferee spouses. The amount of the transferor spouse's income would be equal to the instrument's value upon vesting, and the transferee spouse's income (loss) would be equal to the appreciation (depreciation) of the instrument after vesting. But this approach would result in the same undesirable administrative burdens that afflicted the approach adopted by the 2000 FSA, which was quickly jettisoned by the IRS. Most significantly, the splitting of income approach would require premature valuations of options (i.e., valuation at the time of vesting, rather than at exercise), yet the current taxation scheme with respect to options is based on the view that such valuations are unduly difficult.¹¹⁸ Accordingly, we do not believe that the IRS would adopt this approach. Instead, when unvested stock rights are transferred, we believe there will be a single taxable event at the normal time (upon exercise for NQSOs), but the transferor, rather than the transferee, will simply be taxed on the entire amount of gross income.¹¹⁹

While the 2002 ruling's carve-out and explicit citation to *Kochansky* strongly imply that the transferor of unvested rights will remain subject to tax, a somewhat-bizarre private letter ruling ("PLR") issued in 2010 casts some doubt on that conclusion. In PLR 201016031, the IRS ruled that restricted stock transferred in a divorce was taxable to the *transferee* spouse upon vesting,¹²⁰ which is the direct opposite of the result in *Kochansky*.¹²¹ The PLR discussed

118. See *supra* note 100 and accompanying text. It is possible that, under a splitting of income approach, all of the income would still be realized upon the traditional taxable event (e.g., the exercise of an option) but that the resulting income would be split between the parties at that time based on the fair market value of the option at the time of the transfer. But even that method would require a premature valuation of the option in order to determine the split.

119. In fact, this "single taxable event" approach was adopted by the IRS in private letter rulings involving gratuitous transfers of compensatory stock options, even though such an approach does not seem to be required by the relevant statute or regulations. See, e.g., I.R.S. Priv. Ltr. Rul. 1999-52-012 (Dec. 29, 1999) (ruling that, when compensatory options are transferred by gift, there is no taxable event until exercise, at which point the *transferor* pays tax on the entire option spread); I.R.S. Priv. Ltr. Rul. 94-21-013 (May 27, 1994) (same). While divorce-related transfers are not gratuitous (and, in any event, these rulings are not binding), they are suggestive of the IRS's reluctance to tax compensatory options before exercise due to valuation concerns, even though part of the transferee's gain is attributable to his or her investment decision to delay exercise after vesting.

120. I.R.S. Priv. Ltr. Rul. 2010-16-031 (Apr. 23, 2010).

121. Compare *id.* (ruling that the "income attributable to the vesting of the restricted stock is includible in [the transferee's] gross income"), with *Kochansky*, 92 F.3d at 958 (holding that, where the transferor spouse transferred a one-half interest in a future contingent fee, the entire fee was nevertheless includible in the transferor's gross income).

Revenue Ruling 2002-22 but strangely did not even mention the carve-out for unvested rights, nor did the ruling mention *Kochansky*.¹²² The PLR included no analysis of the unvested-versus-vested issue. It simply noted that the divorce decree provided that the parties intended “a result consistent with Revenue Ruling 2002-22” and required the transferee spouse to be “responsible for paying all costs attributable to [the transferee’s] allocation of restricted stock, including taxes”¹²³

The ruling’s neglect of *Kochansky* is particularly surprising. As discussed above, the transfer of restricted stock is perfectly analogous to the facts in *Kochansky*, and the ruling discussed Revenue Ruling 2002-22 but ignored the carve-out, which explicitly refers to that case. One could interpret the ruling as extending Revenue Ruling 2002-22’s approach to even unvested rights. But private letter rulings do not constitute binding precedent on the IRS, except with regard to the particular taxpayers to whom they are issued,¹²⁴ while Revenue Ruling 2002-22, like all revenue rulings, represents an official interpretation of the law by the IRS and is therefore broadly binding on the agency.¹²⁵ The more recent, nonbinding guidance points in one direction, while the older, binding guidance points in the opposite direction. Complicating matters further, neither ruling includes any significant reasoning or analysis.

Accordingly, the best that can be said about transfers of unvested rights is that their tax treatment remains highly uncertain.¹²⁶ The implications of this uncertainty for practitioners are discussed below Part IV.D. Adding to this confusion is the employment tax treatment of transfers of stock rights in divorce. As discussed below in Part

122. I.R.S. Priv. Ltr. Rul. 2010-16-031 (Apr. 23, 2010).

123. *Id.* The divorce decree provided that while the transferee spouse was generally responsible for paying taxes on the restricted stock, the transferor was responsible for paying employment taxes. Employment taxes are discussed below.

124. See Rev. Proc. 2014-1, 2014-1 I.R.B. 1; see also Rogovin & Korb, *supra* note 105, at 330–36 (describing revenue rulings and their legal effect).

125. See IRS, CHIEF COUNSEL DIRECTIVES MANUAL 32.2.2.10(4) (Sept. 16, 2011), available at http://www.irs.gov/irm/part32/irm_32-002-002.html.

126. Further complicating matters is the fact that, in FSA 200005006, the IRS took the position that the *timing* of the taxable event should be accelerated to the time of the transfer of the options in the divorce. If the IRS takes the position in the future that transfers of unvested stock rights are subject to the assignment of income doctrine rather than § 1041, it could also take the position that the transferor is subject to tax at the time of the transfer of the unvested property (rather than at the time of the normal taxable event, such as exercising an option). However, as discussed above, there does not appear to be strong legal support for this approach since the assignment of income doctrine generally does not affect the timing-of-income inclusion. See *supra* note 96 and accompanying text.

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III.C, the IRS has adopted a counterintuitive approach that treats transfers of vested stock rights differently for employment tax purposes than for income tax purposes.

C. *Employment Tax Consequences of Transferring Vested Stock Rights in Divorce*

While Revenue Ruling 2002-22 clarified the *income* tax consequences of some transfers of compensatory stock rights in divorce, it did not address the employment tax, income tax reporting, or withholding tax consequences of these transfers. The IRS subsequently issued Revenue Ruling 2004-60,¹²⁷ which explained that, for employment tax purposes, the income realized by the transferee spouse pursuant to Revenue Ruling 2002-22 is nevertheless still treated as wages of the *transferor* (employee) spouse.¹²⁸ Thus, for example, upon the transferee's exercise of a stock option, the resulting income will be shown on the transferor spouse's W-2 as wages and will therefore be subject to employment tax withholding at the transferor's employment tax rate.¹²⁹ That rate depends on the amount of the transferor's wages to date at the time of the exercise.¹³⁰ In 2014, the first \$117,000 of wages were subject to an employment tax rate of 7.65%; the next \$83,000 (\$133,000 if the taxpayer is married and filing jointly) to a 1.45% rate; and all remaining wages to a 2.35% rate.¹³¹

The 2004 ruling also explained the income tax reporting and withholding requirements in this context. Upon the relevant taxable event, the employer is to report the gross income to the transferee on a Form 1099-MISC issued to the transferee¹³² and also to withhold at the supplemental wage withholding rate (generally 25%¹³³). The

127. Rev. Rul. 2004-60, 2004-1 C.B. 1051.

128. *Id.*

129. *Id.*

130. INTERNAL REVENUE SERV., PUBL'N 15, (CIRCULAR E), EMPLOYER'S TAX GUIDE FOR USE IN 2014, at 1-2 (2013), available at <http://www.irs.gov/pub/irs-prior/p15--2014.pdf>.

131. *Id.* (providing for a 6.2% Social Security tax rate plus a 1.45% Medicare tax rate on first \$117,000 of wages; a 1.45% Medicare rate on wages up to \$200,000; and an additional 0.9% Medicare rate on wages over \$200,000).

132. Rev. Rul. 2004-60, 2004-1 C.B. 1051 ("Because there is no provision for the issuance of Form W-2 in the name of a nonemployee spouse, the income realized upon the exercise of the nonstatutory stock options would be reportable to the nonemployee spouse . . . on Form 1099-MISC . . .").

133. Once supplemental wages reach \$1,000,000, the supplemental wage-withholding rate is increased to 39.6%. See INTERNAL REVENUE SERV., *supra* note 130, at 18.

withheld amounts are credited against the transferee's year-end income tax liability.¹³⁴

In practice, these rules work as follows with respect to options. Typically, holders of compensatory stock options exercise and then immediately sell the underlying stock in a cashless exercise. In such a case, the employer would deliver cash to the transferee in an amount equal to the spread between the stock price (at the time of exercise) and the strike price, with reductions for supplemental wage withholding (generally 25%) and employment tax withholding (calculated with reference to the transferor's wages to date). SARs and PSUs, which are always settled in cash,¹³⁵ have similar results: the employer delivers the cash amount required under the appropriate formula, with reductions for supplemental wage withholding and employment tax withholding. In all cases, the employer reports the gross income amount to the transferee on a Form 1099-MISC.¹³⁶

The 2004 ruling is counterintuitive, which can cause confusion. The 2002 ruling provides that the *transferee* pays income tax upon the normal taxable event, and that tax is determined using her marginal tax rate.¹³⁷ In contrast, the 2004 ruling requires that the employment tax liability be determined by using the marginal employment tax rate of the *transferor*.¹³⁸ This inconsistency can lead to disputes as to which spouse bears the burden of employment taxes. On the one hand, the 2004 ruling directs the employer to withhold employment taxes from the payment to the transferee,¹³⁹ which suggests that the transferee will bear the burden. On the other hand, the transferor spouse gets Social Security credit for the associated wage income, and the employment tax is calculated with reference to the transferor spouse's W-2 wages, which could imply that the transferor will bear the employment tax burden. The planning implications of this inconsistency are discussed below in Part IV.C.

IV. TAX-PLANNING ISSUES

As detailed in Part III, the taxation of transfers of vested stock rights has recently been clarified, while the taxation of unvested rights remains highly uncertain. Given the state of the law, there are a host of tax-planning issues for practitioners to consider. There may be

134. Rev. Rul. 2004-60, 2004-1 C.B. 1051.

135. See *supra* Part I.C.

136. Rev. Rul. 2004-60, 2004-1 C.B. 1051.

137. See Rev. Rul. 2002-22, 2002-1 C.B. 849.

138. Rev. Rul. 2004-60, 2004-1 C.B. 1051.

139. *Id.*

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some opportunities for favorable income shifting from a high-bracket spouse to a lower-bracket spouse. In addition, even where the law is clear, it is complicated enough to cause confusion and the potential for future disputes if the marital settlement agreement is not drafted carefully. Finally, given the ambiguity of the law with respect to unvested rights, planners should think carefully about how to proceed in that context. This Part discusses these planning issues.

A. *Consider Transfers of Vested Rights to Take Advantage of Transferee's Lower Tax Rates*

If the transferor is expected to be in a higher marginal tax bracket than the transferee following the divorce, transfers of vested options, SARs or PSUs, can be used to save significant amounts of taxes. Under Revenue Ruling 2002-22, the transferee steps into the shoes of the transferor with respect to the income tax consequences;¹⁴⁰ accordingly, the ordinary income stemming from the ultimate taxable event will be reported by the lower-bracket spouse. Had the stock right been retained by the higher-bracket spouse, the ordinary income would have been reported by that spouse. This higher-bracket to lower-bracket income shift results in a “tax surplus” that augments the marital estate, allowing both parties to benefit at the expense of the national fisc.¹⁴¹

In fact, stock rights provide a unique opportunity to easily shift large amounts of ordinary income between spouses. Typically, only capital gains can be easily shifted (through transfers of investment assets), but the advantage of shifting capital gains is more limited because of the relative flatness of the capital gains tax-rate structure.¹⁴² Alimony payments could also be used to effectively shift ordinary income from the higher-bracket spouse to the lower-bracket spouse,¹⁴³ but alimony payments are governed by complicated front-loading rules, which generally require the payments to be spread

140. Rev. Ruling 2002-22, 2002-1 C.B. 849.

141. Although the transferee spouse will bear the nominal burden of the tax, the two spouses can effectively split the tax benefit by having the transferor spouse adjust the total value of assets he transfers.

142. See I.R.C. § 1(h) (2012) (providing for a 15% capital gains rate for taxpayers in the 25%, 28%, 33%, and 35% tax brackets and a 20% capital gains rate for taxpayers in the 39.6% bracket). Section 1411 adds a 3.8% additional “net investment income” tax on capital gains for taxpayers in the 39.6% bracket, and phaseouts can cause the effective marginal tax rate for high-bracket taxpayers to reach 25%. See *id.* § 1411(a)(1).

143. See *id.* §§ 71, 215(a) (providing for the inclusion by the transferee and deduction by the transferor of alimony payments).

evenly over three taxable years.¹⁴⁴ In addition, alimony payments must automatically cease upon the death of the transferee in order to achieve the desired income shifting,¹⁴⁵ but cessation upon death may be inconsistent with the parties' desires in effecting the equitable distribution. While the impact of the front-loading and cease-upon-death alimony rules is not insurmountable,¹⁴⁶ tax planners do not have to worry about the cost and complication of circumventing these rules when compensatory stock rights are transferred.¹⁴⁷ Accordingly, transfers of vested stock rights are the easiest way to shift ordinary income from the higher-bracket spouse to the lower-bracket spouse.

B. Consider Avoiding Transferring ISOs

If an ISO is transferred in connection with a divorce, the option automatically converts to NQSO status because of the statutory condition that an ISO be nontransferable.¹⁴⁸ ISOs provide better tax results to the holder if the holding-period conditions are satisfied.¹⁴⁹ Because of the automatic loss of the potential tax benefits resulting from ISO status, it would not appear to be tax efficient to transfer ISOs as part of an equitable distribution.¹⁵⁰ However, if the holding-

144. *See id.* § 71(f)(1) (providing for recapture of "excess alimony payments").

145. *See id.* § 71(b)(1)(D).

146. For example, a December 31 divorce date, combined with three roughly equal payments and a one-year insurance policy, could effectively circumvent these rules. One payment would be due on December 31 of the current year, another due on January 1 of the following year, and the last due on the following January 1. Insurance on the life of the transferee for one year would protect the transferee against not receiving the full amount of the bargained-for equitable distribution.

147. Alimony payments must be made in cash, so transfers of compensatory stock rights would not be subject to the alimony rules. *See* I.R.C. § 71(b)(1).

148. *See* Rev. Rul. 2002-22, 2002-1 C.B. 849 (explaining that a transfer of an ISO incident to divorce would immediately disqualify the option because of the statutory condition of nontransferability in I.R.C. §§ 422(b)(5) and 423(b)(9)). However, the transfer of the underlying stock incident to a divorce (rather than the ISO itself) would not be a disqualifying disposition, regardless of when it occurred. *See* I.R.C. § 424(c)(4). Thus, the employee spouse could exercise an ISO prior to the divorce and then transfer the underlying stock in the divorce without triggering a disqualifying disposition, which would mean that, provided that the transferee spouse holds the stock long enough, the favorable capital gains treatment would apply. If the transferee spouse disposes of the stock before the end of the requisite holding period (taking into account the transferor's holding period), then I.R.C. § 424(c)(4) makes clear that the transferee would realize ordinary income upon the disqualifying disposition. *See id.*

149. *See supra* notes 45–47 and accompanying text.

150. It is not clear whether a constructive-trust-type structure would work to circumvent the ISO rule prohibiting transfers. A constructive trust would have the employee spouse retain legal ownership of the ISO but also allow the nonemployee spouse to choose when to exercise the ISO, sell the underlying stock, and receive the after-tax proceeds from the sale. Under general tax law principles governing ownership for tax

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period condition would not be satisfied by the transferor if the transferor were to retain the ISO, then there would be no tax cost in losing ISO status because the tax results would replicate those stemming from NQSOs.¹⁵¹ Accordingly, in deciding whether to transfer ISOs as part of an equitable distribution, the parties would need to weigh the expected tax cost of losing ISO status, which depends on the likelihood of satisfying the holding-period condition, against the burden of relying on transfers of only non-ISO assets to effect the equitable distribution.

The principal burden of relying on only non-ISO assets to effect the equitable distribution is the need to value the ISOs. If ISOs are part of the marital estate but are not transferred, the ISOs would need to be valued and the transferee spouse's share of the ISOs would need to be offset by other property transferred to or retained by such spouse. Because, as explained more fully below, option valuation is difficult and subject to dispute, divorcing parties tend to prefer simply splitting the options to avoid valuation costs and disputes.¹⁵²

C. Make Clear Which Spouse Will Bear the Incidence of the Various Taxes

The 2002 and 2004 revenue rulings explained the mechanics in taxing, reporting, and withholding with respect to divorce-related transfers of vested stock rights. The transferee ultimately includes the gross income on the transferee's own federal income tax return. Even though it may seem obvious that the transferee is responsible for paying the resulting increase in his income tax, to avoid any confusion

purposes, legal title is not dispositive, and the nonemployee spouse would likely be considered the tax owner of the ISO under a benefits-and-burdens analysis. Two IRS private letter rulings (which do not constitute binding precedent) have determined that constructive trusts did not result in ISO disqualification, but these rulings involved taxpayers in community property states, where the ISOs could be considered as owned by the transferee spouse for tax purposes even before the constructive trust was created. *See* I.R.S. Priv. Ltr. Rul. 2007-37-009 (Sept. 14, 2007); I.R.S. Priv. Ltr. Rul. 2005-19-001 (May 13, 2005).

151. As noted above, the taxation of disqualifying dispositions of ISOs replicates the taxation of NQSOs. In fact, the tax treatment is identical if the disqualifying disposition occurs in the same taxable year as the exercise, as would be the case in a cashless exercise. Otherwise, there would be a slight timing difference. *See supra* note 51 (explaining the near-equivalence and the potential timing discrepancy).

152. *See* Charles F. Vuotto, Jr. & Jeffrey D. Urbach, *Stock Option Distribution via Constructive Trusts in Divorce Settlements*, TONNEMAN, VUOTTO, ENNIS, & WHITE LLC, <http://www.tvelaw.com/wp-content/uploads/2012/06/StockOptionDistributions.pdf> (last visited Nov. 3, 2014) (explaining the preference for the "deferred distribution approach" over valuing stock rights).

the marital settlement agreement or divorce decree should state that the income tax burden is to be borne by the transferee. The agreement or decree should also describe the required reporting and withholding mechanics as well, to avoid any surprises or misunderstandings.

With respect to employment taxes, it is even more important for the marital settlement agreement or divorce decree to specify which party will bear the burden of those taxes. There is a significant potential for confusion because the employment tax burden will be determined by reference to the transferor's taxable wage base. In addition, the transferor will get FICA credit for those taxes with respect to the wages up to the FICA wage base, which is currently \$117,000.¹⁵³ However, in the typical case, this credit will have no actual effect on the transferor's Social Security entitlements.¹⁵⁴ On the other hand, Revenue Ruling 2004-60 explicitly provides that the payment from the employer to the transferee is to be net of the required employment tax withholding.¹⁵⁵ Therefore, absent any affirmative duty of the transferor spouse to reimburse the transferee for that amount, the transferee will bear the burden of employment taxes.

Should the transferor be required to reimburse the transferee for the employment taxes withheld by the employer? If options are split, the transferor will bear the employment taxes on her retained options, so it would seem that the transferee should bear the burden with respect to the transferred options. In addition, the fact that the transferor spouse typically would receive no increase in Social Security entitlements from the inclusion of the wages in the transferor's wage base supports the conclusion that the burden should remain on the transferee. The employment taxes are therefore simply a cost of exercising the option with no accompanying benefit to the transferor.

One complication, if the transferee retains the employment tax burden, is that the applicable employment tax rate will change over the course of the taxable year as the year-to-date wages increase. In 2014, the first \$117,000 of wages is subject to employment taxes at a rate of 7.65%, the next \$83,000 of wages at a rate of 1.45%, and all

153. See *supra* notes 130–31 and accompanying text.

154. For instance, if the transferor would have realized \$117,000 of wages in 2014 irrespective of the stock rights, then there would be no effect because there is no Social Security effect for receiving wages above the wage base.

155. Rev. Rul. 2004-60, 2004-1 C.B. 1051.

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remaining wages at a rate of 2.35%.¹⁵⁶ It would not be appropriate for the transferee to bear the full 7.65% burden in the typical case where the transferor spouse's own wages (i.e., salaries, bonus, taxable benefits, and income from that spouse's own stock rights) would exceed \$117,000. In situations involving very highly compensated executive transferors, the transferee spouse can usually avoid the 7.65% rate simply by avoiding exercises or payouts in the early part of the calendar year. For instance, if the executive's annual salary is \$600,000 per year, then by the end of March the executive's wages from salary alone will already have surpassed the 7.65% employment tax bracket.¹⁵⁷ If this sort of self-help is infeasible or otherwise undesirable, then the transferee should negotiate for an indemnification of employment tax withholding that is in excess of the standard 1.45% or 2.35% rates.¹⁵⁸

D. Dealing with Unvested Stock Rights

As explained in Part III, the tax consequences resulting from divorce-related transfers of unvested stock rights remain highly uncertain. The carve-out and citation to *Kochansky* in Revenue Ruling 2002-22 imply that the transferor will be taxed,¹⁵⁹ while a 2010 private letter ruling suggests instead that the transferee will be taxed.¹⁶⁰ The 2010 ruling, however, is not binding on the IRS. Given this uncertainty, what should advisors do with regard to unvested rights?

156. See *supra* notes 130–31 and accompanying text.

157. In that case, the executive's monthly paycheck would be a bit less than \$50,000 (a bit less due to excluded benefits, such as health insurance as well as, potentially, elective deferrals).

158. The rate should be the marginal employment tax rate that applies to the stock rights. Thus, if the transferor's own wages would result in the transferor being taxed at the margin at 2.35% (i.e., because the transferor's own wages exceed \$200,000), then the 2.35% tax rate should be used. This could actually require the transferee to reimburse the transferor if the wages from the stock rights cause the transferor to lose some or all of the benefit of the 1.45% rate that applies to wages between \$117,000 and \$200,000 (or \$250,000 if the transferor files a joint return). For instance, assume that after the transferor (who is single) realizes wages of \$117,000, the transferee exercises options with a spread of \$83,000; the transferor then realizes additional wages of \$83,000. Without any indemnity by the transferee, the transferee would receive the benefit of the low 1.45% rate on the \$83,000 of stock-right income. But absent the stock-right income, the transferor would have realized the benefit of that low rate. In that case, the transferee should, in theory, be required to reimburse the transferor for the extra employment tax paid (\$747, which is \$83,000 x .009), but it is probably not worth the trouble.

159. See *supra* note 111 and accompanying text.

160. See *supra* note 120 and accompanying text.

1. Avoid Transferring Unvested Rights

One obvious, though often unattractive, approach is to simply avoid transferring any unvested items in the first place. If an equitable distribution can be accomplished by transferring only cash, vested stock rights, and other property, then the tax uncertainty is avoided. The problem with this approach is that it requires the valuation of the unvested stock rights. This is because the transferee spouse's portion of the unvested stock rights must be offset with other property. Because valuation of these rights is fraught with complexities, divorcing parties often desire to simply split existing compensatory stock rights, rather than attempting the arduous task of valuing the options.¹⁶¹ Splitting options also may be the ideal approach for sharing the risk of non-vesting. If the transferor spouse retains all of the unvested rights, but transfers equivalent value property as an offset, then the transferor would bear the entire risk of non-vesting.¹⁶² Alternatively, the risk of non-vesting could be priced into the offset, but this would lead to even further complications and opportunities for disagreement.

For those reasons, a so-called “deferred distribution” approach is often most desirable.¹⁶³ To illustrate this approach, assume that an employee spouse owns 100 options that had an original four-year vesting period, that the options are part of the marital estate, and that the filing of the divorce petition (or other appropriate cut-off date¹⁶⁴) occurs exactly two years after grant. Rather than attempt to value the 100 unvested options as part of the marital estate and have the employee spouse retain all of the options, the parties could agree that the nonemployee spouse simply be transferred twenty-five of the options. (The nonemployee spouse might receive twenty-five options rather than a full share of fifty because half of the vesting period is attributable to the post-marital services of the employee.¹⁶⁵) When a

161. See Vuotto & Urbach, *supra* note 152 (describing the difficulty in valuing stock options, particularly unvested ones, and explaining that the deferred distribution approach is typically preferred over valuing and offsetting options).

162. See Jeffrey D. Urbach, *Equity-Based Compensation: Stock Options*, in FAMILY LAW SERVICES HANDBOOK 113, 121 (Donald A. Glenn et. al. eds., 2011) (explaining that, if valuation and offset were used, the employee spouse would bear the entire risk of termination before vesting).

163. See *id.* (noting that “deferred distributions” are the most common way of allocating options); Vuotto & Urbach, *supra* note 152;

164. E.g., the date of the separation agreement.

165. Cf. Callahan v. Callahan, 321 A.2d 561, 564 (N.J. Super. Ct. Ch. Div. 1976) (distributing 25%, rather than 50%, of unvested options, all of which were marital property, to the nonemployee spouse presumably because the vesting period continued into the post-marital period).

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deferred distribution approach is used, the transferor transfers a pro rata portion of each type of stock right, whether vested or vested to the transferee. Accordingly, the desire to avoid the tax uncertainty from transferring unvested rights conflicts with the nontax goal of avoiding option valuation, and the nontax goal typically prevails.

2. Delay Until Vesting

If vesting of significant stock rights is scheduled to occur in the near term, the parties could delay executing the marital settlement agreement until after the vesting date. This delay effectively converts the transfer of unvested rights into the transfer of vested rights, which makes the tax uncertainty disappear, at least with respect to those rights.¹⁶⁶ Of course, the parties may not wish to delay executing the marital settlement, so this may not be an attractive option even if vesting is imminent. Furthermore, while this approach resolves the uncertainty with respect to batches of stock rights that will vest in short order, there may be other, longer-vesting batches.

3. Private Letter Ruling Request

Another option would be to request a private letter ruling from the IRS. Seeking such a ruling would involve some additional cost and could take several months, and a favorable ruling cannot be assured.¹⁶⁷ However, the fact that the IRS issued an analogous letter ruling in 2010 on the issue would ease these concerns somewhat.¹⁶⁸ If significant amounts of unvested rights will be transferred and delay is not a significant concern, a letter ruling request should be considered. The letter ruling approach would be particularly attractive if the transferee is expected to be in a lower tax bracket than the transferor. As the next subpart explains, a constructive trust approach can be used, but it would require the transferor to pay the income tax. And, as described above, the transferor could retain unvested items, but

166. Another possibility might be to delay the effective date of the divorce or transfers of the options, rather than the execution of the marital settlement agreement, until after the vesting date. However, conservative tax practitioners might be concerned that the IRS would consider the transfer to be effective for tax purposes upon the date of execution of a marital settlement agreement that requires the transfer to be made; if so, the employee spouse would be treated as transferring unvested stock rights.

167. See, e.g., Michael J. Jones, *A Costly and Unnecessary Detour*, WEALTHMANAGEMENT.COM (May 1, 2008), <http://wealthmanagement.com/retirement-planning/costly-and-unnecessary-detour-0> (explaining that the user fee for PLRs can be \$11,500 or more and that PLRs can take anywhere from a few months to a year to obtain).

168. I.R.S. Priv. Ltr. Rul. 2010-16-031 (Apr. 23, 2010).

that also would require the transferor to pay the income tax.¹⁶⁹ A private letter ruling appears to be the only way to ensure that gross income from unvested rights is properly reportable by the transferee, and the tax arbitrage benefits from the resulting income shift could outweigh the cost and delay of obtaining the ruling.

4. Constructive Trust Approach

If the above approaches are not attractive, the best alternative would be for the parties to agree that the transferor spouse will (i) retain legal title to the transferee's share of the unvested stock rights, (ii) report the taxes resulting from the taxable event, and (iii) transfer the after-tax amount to the transferee spouse. Thus, while the transferor would nominally pay the taxes, the transferee will bear the economic burden. This arrangement is referred to as a constructive trust because the transferor holds legal title to the stock rights for the benefit of the transferee.¹⁷⁰

In the case of stock options, the transferor would agree to exercise the options and sell the underlying stock upon the direction of the transferee and then immediately transfer the after-tax proceeds of the sale to the transferee. In the case of restricted stock, the transferor spouse would transfer, immediately after vesting, the after-tax amount of shares (or, if the transferee directs a sale of those shares, the after-tax amount of proceeds from the sale of those shares) to the transferee. In the case of SARs, the transferor would agree to "exercise" the SAR at the direction of the transferee and transfer the after-tax amount of cash proceeds to the transferee. Finally, in the case of PSUs, the transferor would transfer the after-tax amount of cash proceeds upon the specified payout date.

A constructive trust would likely not alter the fact that the unvested items have been transferred for tax purposes because legal title is not dispositive as to tax ownership.¹⁷¹ Instead, tax ownership generally is determined based on the party who bears the "benefits

169. *See supra* Part IV.D.1.

170. A constructive trust approach can also be used for vested stock rights in cases where the employer does not permit the employee spouse to transfer those rights, even in connection with a divorce. As explained below, the constructive trust approach should not alter the conclusion that the items have been transferred for tax purposes; thus, the tax consequences should be the same as if legal title to the rights were actually transferred.

171. *See, e.g.*, *Comm'r v. Sunnen*, 333 U.S. 591, 604-05 (1948) (holding that control over property, rather than legal title, determines tax ownership); *Grodt & McKay Realty, Inc. v. Comm'r*, 77 T.C. 1221, 1237-38 (1981) (citing ownership of legal title as one of eight relevant factors in determining ownership for tax purposes).

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and burdens of ownership” of the property.¹⁷² Because the transferee benefits from the appreciation and suffers from the depreciation of the transferee’s share of the stock rights and because the transferee has the power to direct when stock options and SARs are exercised, the transferee should be considered to have tax ownership.

Even though the constructive trust approach should not alter the conclusion that the stock rights have been transferred, the approach remains attractive for a number of reasons. First, the ultimate tax reporting by the transferor is consistent with Revenue Ruling 2002-22’s carve-out of unvested items and its citation to *Kochansky*.¹⁷³ Second, in most cases, the transferor will be in the same or higher tax bracket than the transferee, which means that the IRS would realize no additional revenue on an overall basis (and may even realize a reduction in revenue) by challenging the parties’ agreed-upon approach. Thus, if the IRS were to retreat from its carve-out in Revenue Ruling 2002-22 and seek to tax the transferee on the stock rights, it would not realize any additional revenue and would serve only to disrupt the parties’ agreed-upon allocation of the tax burden.¹⁷⁴ This should diminish even further the remote possibility that the IRS would reverse course. Third, employers sometimes preclude or discourage employees from transferring unvested stock rights, even in a divorce, which would make a constructive trust necessary if splitting unvested rights (in lieu of valuing them) is desired. Fourth, because legal title to the relevant items remains in the hands of its employee and the eventual tax consequences are reported on the employee spouse’s W-2, the employer’s procedures for reporting the income are unaffected by the divorce. This simplifies the employer’s reporting and withholding procedures and reduces the likelihood of any errors or complications.

The constructive trust arrangement should include some technical provisions to ensure that it achieves the desired results. First, the transferor spouse, who has agreed to report the income from the unvested stock rights upon the appropriate taxable event, should indemnify the transferee spouse in the event that the IRS were to decide that the Revenue Ruling 2002-22 methodology (of taxing

172. See *Grodt*, 77 T.C. at 1237.

173. See *supra* note 111 and accompanying text.

174. As discussed below, the transferee should negotiate for an indemnity to apply in that situation. In that case, the transferee in the end would bear only a single tax burden (but at the transferee’s rate, rather than at the transferor’s).

the transferee) is appropriate even for unvested rights.¹⁷⁵ This indemnity serves two purposes. It ensures that the transferee spouse is not effectively taxed twice on the rights, first by receiving only the after-tax proceeds from the transferor and again when the IRS asserts a deficiency against the transferee. The indemnity will also discourage the transferor from making an opportunistic claim for refund because any benefit from the claim for refund would be offset by the indemnity. The latter purpose is likely more important because the IRS would almost certainly not choose to challenge the parties' agreed-upon allocation of the tax burden unless the transferor were to file a claim for refund, which would require the IRS to affirmatively act either by denying or accepting the claim.

Second, to calculate the after-tax payments that go to the transferee spouse upon the appropriate taxable event, the transferor's applicable tax rate needs to be determined. In theory, that rate should be the actual combined (i.e., federal, state, and local) effective marginal tax rate on the taxable income in question. However, there are some practical problems in using the actual rate. The actual rate will be determinable only after the transferor has filed all of his tax returns for the taxable year in which the taxable event occurs. Thus, using the actual rate would require a two-step process. First, an assumed rate would be used to determine the tentative tax on the stock-right income. The transferor would immediately transfer the proceeds less the tentative tax. Second, after the transferor's tax returns for the year have been filed, a true-up adjustment payment would be made by either the transferor (if actual tax rate turns out to be lower than the assumed rate) or by the transferee (vice versa). To determine the actual tax rate, the transferor's actual tax liability for the taxable year would have to be compared with the transferor's hypothetical tax liability if the taxable income from the stock right in question was not included.¹⁷⁶ Accordingly, "dummy" tax returns (i.e., returns prepared but not filed), including state and local returns in jurisdictions that have income taxes, would have to be prepared for each year in which the transferor realizes stock-right income on behalf of the transferee. Preparing these dummy tax returns would

175. The indemnity would require the transferor to reimburse the transferee for any income taxes that reduced the payment to the transferee. The transferor would be able to recover that amount from the IRS through a claim for refund based on the IRS's reversal of the carve-out language in Rev. Rul. 2002-22.

176. Because of the complex interaction between state and local taxes and federal taxes and the multitude of phaseouts that potentially apply, the real rate is often not determinable without actually preparing a second set of dummy tax returns.

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involve some cost.¹⁷⁷ In addition, the entire procedure can be viewed as unwieldy, particularly because the transferor spouse would have to share sensitive tax information with her former spouse to allow the latter to confirm that the calculations are correct. The benefits of precision from using the actual rate must be weighed against the cost, complexity, and information-sharing issues arising from using the actual rate. In many cases, the precision benefits of using the actual rate are not worth the trouble.

The alternative is for the parties to agree to a stipulated rate. For very high-income transferors, something like “the sum of the highest marginal federal income tax rate in § 1 of the Internal Revenue Code, the highest Medicare tax rate (including the additional 0.9% Medicare tax rate) and the highest state and local income tax rate then in effect in the applicable state and local jurisdictions” could be used. This stipulated rate would not be perfect. It might err on the high side because state and local income taxes are generally deductible, which lowers the combined effective marginal tax rate.¹⁷⁸ On the other hand, the assumed rate does not take deduction phaseouts and other similar hidden tax rate increases into account. In many cases, these two competing effects (i.e., disregarding the deductibility of state and local taxes and disregarding phaseouts) can end up roughly canceling each other out. Alternatively, a stipulated nominal rate, such as 50%, could be used.¹⁷⁹ In that case, the parties should consider an automatic adjustment if statutory rates eventually change by more than an insignificant amount.

Once the tax rate—whether actual or stipulated—is determined, the transferor would use that rate in determining the amount of payment that he must deliver to the transferee shortly after the taxable event (i.e., vesting, exercise, or payout). If a stipulated rate is used, a single, correct payment amount can simply be delivered for each event. As described above, if the actual rate is used, a more complicated two-step payment process would be required.

177. In addition, if the transferor’s actual rate is used, procedures would have to be developed to deal with the situation where the transferor ends up filing an amended return because the changes on that return could change the effective rate of tax paid by the transferor on the stock-right income.

178. And although taxpayers subject to the AMT will lose the benefit of their state and local tax deductions, the effective marginal rate in those cases would still be lower than the highest marginal rate under the regular income tax. *See* I.R.C. § 1 (2012) (providing top rate of 39.6%).

179. *See, e.g.,* Vuotto & Urbach, *supra* note 152 (providing sample constructive trust terms using a 44% stipulated tax rate).

V. RECOMMENDATIONS FOR REFORM

As discussed above, while Revenue Ruling 2002-22 settled the treatment of transfers of vested stock rights in divorce, the treatment of transfers of unvested stock rights remains unclear. The language in the ruling seems to suggest that the transferor remains taxable on these items, while a nonprecedential private letter ruling allowed for the opposite result. This uncertainty necessitates the socially wasteful tax planning discussed in Part IV.D., and even after engaging in this planning, taxpayers still are at risk that the IRS could disagree with the approach taken. To avoid these unnecessary costs and complexities, the tax administration should immediately issue precedential guidance on which taxpayers could rely.¹⁸⁰

One possibility would be for the Treasury to promulgate a regulation or for the IRS to issue a revenue ruling that would require the transferor spouse to report the income from unvested stock rights upon the eventual taxable event. For transfers of restricted stock that will vest upon the performance of services by the transferor spouse, as well as settled-upon-vesting PSUs, the assignment of income doctrine appears to require that result.¹⁸¹ For transfers of other types of stock rights, such as unvested NQSOs, the tax treatment is more uncertain because the taxable event occurs not upon vesting (i.e., “earning”) but upon subsequent exercise.¹⁸² Thus, some or perhaps all of the taxable income is attributable not to the transferor’s services, but rather to the transferee’s investment decision to delay exercise after vesting. Although this suggests that the purely correct tax treatment would be to split the income between the transferor and transferee

180. In theory, Congress could enact a clarifying statute, but given the current hostile tax legislative climate as well as the fact that Congress typically has left technical assignment of income issues to the Treasury and IRS, *see, e.g.*, Rev. Rul. 2002-22, 2001-1 C.B. 849, we are not optimistic about the prospect of legislative reform. Of course, if Congress were to intervene, it could do so on a clean slate, unburdened by existing doctrine and based purely on policy considerations, unlike the executive agencies, which must ensure that their rulings are consistent with the existing statutory scheme. From a pure policy perspective, the issue is whether the greater precision of taxing unvested rights to the transferor justifies the additional complexity from having completely different tax regimes for taxing vested versus unvested rights. For the reasons discussed below (i.e., the limited revenue at stake and the unlikelihood of behavioral distortion), our sense is that the precision is not worth the administrative cost, so we would recommend that, if Congress were to act, it should provide that the transferee of unvested stock rights is taxed upon the eventual taxable event, consistent with the way that vested rights are taxed.

181. *See Kochansky v. Comm’r*, 92 F.3d 957, 958 (9th Cir. 1996).

182. *See supra* note 118 and accompanying text (explaining that, while the assignment of income doctrine appears to apply neatly to unvested stock, its application to unvested stock options is more unclear because the vesting event and the taxable event do not occur simultaneously).

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spouses, such an approach would require premature valuation of options and create significant administrative complexity. Therefore, we are confident that, if the government were to provide precedential guidance that the transferor of unvested options is taxed in full upon the eventual taxable event, it would constitute a valid exercise of administrative authority.

On the other hand, if the government were to take the contrary position that the transferee is taxed, it is possible that the guidance would be held invalid. Transferees, who may have an incentive to challenge the guidance to avoid paying the resulting tax,¹⁸³ could argue that the guidance is inconsistent with the settled law as evidenced by the *Kochansky* case and other assignment of income authorities. Whether such a challenge would be successful is uncertain, but the risk is significant. And if the guidance were struck down, it could result in avoidance of taxation by transferees, who would argue that the guidance is ineffective against them, as well as transferors, who would argue that the guidance is nevertheless binding on the government vis-à-vis them.¹⁸⁴ Even if the government could ultimately collect tax from transferors, the result would be a potential windfall to transferees at the expense of transferors.¹⁸⁵

To avoid these potential complications, we believe it would be better for the government to issue binding guidance confirming that the transferor remains taxable on unvested rights, which is most consistent with the existing assignment of income doctrine and therefore unlikely to be successfully challenged. While such an approach would eliminate the legal uncertainty, the consequences would still be somewhat complicated because it would result in two diametrically opposed tax regimes, depending on whether stock rights were vested or unvested at the time of the divorce. This inconsistency is counterintuitive and easy to gloss over. For instance, the IRS in PLR 201016031 appeared to overlook the fact that the rights in question were unvested. Furthermore, as explained above, the treatment of vested stock rights is already counterintuitively inconsistent as between *income* tax and *employment* tax

183. It is possible that certain transferees would not have an incentive to challenge the guidance. For instance, a carefully drafted marital settlement agreement should include an indemnity in favor of the transferor that would take away this incentive.

184. A transferor might also avoid tax because the statute of limitations had passed before the IRS sought to tax her.

185. If a contractual indemnity in favor of the transferor was in the marital settlement agreement, *see supra* note 179 and accompanying text, then there would be no windfall.

consequences; having opposite regimes for vested versus unvested rights adds complexity on top of complexity.

With that in mind, the IRS should consider issuing a safe harbor that would allow the parties to provide in their marital settlement that the transferee agrees to be taxed on unvested rights in the same manner as she would have been taxed had the rights been fully vested. The safe harbor would announce that the IRS would respect such an agreement. There are several precedents in the tax law regarding divorce transactions that explicitly allow this sort of private ordering of tax liability,¹⁸⁶ and this would be consistent with that approach.¹⁸⁷

The safe harbor, however, would not be costless. In cases where the transferee is in the lower tax bracket, it allows for additional tax-advantageous income shifting. While this is certainly a cost, our sense is that it is not significant enough to outweigh the administrative advantages of the safe harbor. In many situations, particularly in high net worth divorces, there will not be any tax rate differential to exploit. In addition, to the extent there are tax rate differences, the parties can already exploit them very easily using transfers of vested stock rights. Finally, even if the safe harbor does allow additional income splitting at the margin in a particular case, the advantage is capped because at some point the transferee will be put in the same (or higher) marginal tax rate as the transferor. All of this suggests that

186. See, e.g., I.R.C. § 71(b)(1)(B) (2012) (allowing former spouses to agree to treat payments that would otherwise qualify as deductible and includible alimony as nondeductible and excludible payments); Treas. Reg. § 1.1041-2(c)(1) (as amended in 2003) (allowing former spouses to agree to treat redemptions of corporate stock as distributions on stock); Treas. Reg. § 1.1041-2(c)(2) (allowing former spouses to agree to treat distributions on stock as redemptions).

187. One technical issue is whether a promise by the transferee in the marital settlement agreement to report and pay the eventual tax on unvested stock rights will be binding on the transferee in an action by the IRS to collect the tax if the transferee fails to pay. The resolution depends on whether the IRS is considered a third-party beneficiary of the transferee's promise to the transferor, which is a complicated question intersecting tax and contract law that is beyond the scope of this Article. In a similar private ordering rule in the divorce context, the government appears to believe that it would be a third-party beneficiary. See Treas. Reg. § 1.1041-2(c)(1)–(2) (allowing the divorcing parties to report a transaction in a manner inconsistent with “applicable tax law” provided that they expressly agree that both spouses intend to report the transactions in such a manner). In an abundance of caution, the IRS might consider requiring, as a condition for the application of the safe harbor, the transferee spouse to check a box on a tax form (or attach a statement to the tax return) that waives the right to assert that the assignment of income doctrine causes the income to be taxable to the former spouse. In such a case, the marital settlement agreement should require the transferee to check that box (or attach the statement) to protect the transferor.

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the revenue loss from the safe harbor can be expected to be relatively small.¹⁸⁸

In addition to revenue concerns, the prospect of behavioral distortion needs to be considered. In this context, however, we expect there to be little, if any, distortion. First, stock rights issuances require company action. Stock rights are not going to become more favored simply because there will be marginally greater income-shifting opportunities if and when there is a divorce. And, even in cases where a divorce is imminent, companies are not likely to rush to grant a divorcing executive additional unvested stock rights.¹⁸⁹ Finally, we would expect that the deals struck in marital settlement agreements would not be altered by virtue of this rule. In a world without taxes, the pro rata division of stock rights would usually make the most sense, due to valuation problems. Under the safe harbor approach, we would expect to see the same pro rata division. If anything, taxing the transferor on unvested rights would be more likely to distort marital settlements by encouraging parties where income shifting is beneficial to affect their equitable distribution using only vested stock rights; this would require burdensome valuation of both vested and unvested stock rights. In sum, the behavioral distortion should be negligible.

CONCLUSION

The transfer of stock rights in divorce may create beneficial planning opportunities to shift income from a high-bracket spouse to a lower-bracket spouse. It is now clear that income arising from vested stock options transferred in divorce is taxable to the transferee spouse, and this rule should apply to vested SARs, as well. However, the state of the law with respect to transfers of unvested stock rights remains uncertain. Because the IRS has taken the position in a recent private ruling that income from the vesting of restricted stock transferred in divorce was taxable to the *transferee* spouse, taxpayers may find that the expense of seeking a private ruling justifies the

188. It can also be argued that allowing additional income splitting effectively extends the so-called “marriage bonus” from which the couple was likely benefiting before the divorce. *Cf.* Geier, *supra* note 79, at 365–66 (arguing for allowing easier income-shifting in the context of alimony payments based on the loss of the marriage bonus). While this effect does not reduce the revenue loss from the proposed safe harbor (since the parties will no longer be married regardless of the existence of the safe harbor), it could be used to help justify the safe harbor on fairness grounds. For discussion of the marriage bonus, see generally Lawrence Zelenak, *For Better and Worse: The Differing Income Tax Treatments of Marriage at Different Income Levels*, 93 N.C. L. Rev. 783 (2015).

189. In fact, for nontax reasons, an imminently divorcing executive usually would prefer for the company to delay granting options until after the divorce is final.

assurance of that outcome, particularly if the transferee spouse is in a lower tax bracket than the transferor. In the absence of such a ruling, practitioners should proceed with caution, as Revenue Ruling 2002-22 and *Kochansky* arguably support the position that the transferor spouse remains taxable on income from unvested stock rights transferred in divorce. Taxpayers seeking to avoid this outcome should either avoid transfers of unvested stock rights altogether or adopt a constructive trust approach. While a constructive trust would not allow the parties to take advantage of income shifting to a lower-bracket spouse, it would allow the transferee to effectively bear the burden of the tax while keeping the nominal burden on the transferor. Additionally, because the employment tax burden will be determined by reference to the transferor employee's tax wages in any event, the parties should take care to specify which spouse will ultimately bear the burden of those taxes.

That said, the existing doctrine in this area is unnecessarily confusing and complicated. We therefore suggest that the government issue guidance that (i) clarifies that the transferor is taxed on income from unvested stock rights (for both income and employment tax purposes) upon the eventual taxable event but (ii) nevertheless allows the former spouses to agree that the transferee will be taxed on those rights (consistent with the tax treatment of vested stock rights). Such an approach appropriately balances practical and policy considerations, while insulating the government from potential administrative law challenges.