

Stock Options, the Sequel

By Jill Hersh*

In the article, "Analysis of the Time Rule and the Characterization of Stock Options" (*Family Law News*, Winter, 1996) I discussed the characterization and allocation of stock options. I did not address two other factors that are integral to any understanding of stock options as a marital asset, to wit: (1) the tax implications of stock option division, and (2) the implementation of a division of the options.

Stock options have "invisible" tax consequences, *i.e.*, taxes can be triggered before the actual realization of money.

Most stock options are non-transferable. Therefore, division is problematic and must be done according to a scheme that insulates the employee from taxes attributable to the other spouse's share.

This article deals with the general rules pertaining to taxation and not with the minutiae of the Internal Revenue Code and Regulations. Questions of taxable losses, interpretations of compliance, and detailed descriptions of particular types of options are not addressed in this article.

This article is intended to alert the practitioner to potential tax problems involved in the transfer of stock options. An accountant or tax guides/regulations should be consulted for a fuller analysis.

What Are Stock Options?

Stock options are a benefit of employment (incentive or compensation) that allows the employee to acquire publicly traded stock shares of an employer or parent company at an established price fixed by the employer. The employee's purchase price is called the "option" price.¹

The description of the options, including conditions for vesting and the option price, is contained in a Grant. This is the contract between the employee and the employer pursuant to which the options may be obtained.

The "vesting" date is the date upon which the ownership of the option is perfected or no longer forfeitable. Almost always, a condition precedent of vesting is the continued employment of the employee on the date of vesting.

An option is "exercised" when the right to purchase the stock at the option price is utilized and the stock share is purchased by the employee. After exercise, the stock share is then owned by the employee in the same way as any other stock purchased on the market, except for Incentive Stock Options, where there is a minimum holding period required to obtain the tax benefits.

Most grants require the exercise to occur within a particular period of time (*e.g.*, five years, ten years). If the option is not exercised within that period, it will expire.

Many companies issue new grant documents each year so that an employee is always employed under some option plan and is always in the midst of some vesting period for a block of stock options. For example, an employer may issue a grant in 1997 that states that 1500 shares of A stock at \$10.00 per share will vest every January 1st of the next four years if the employee continues to be employed on January 1st of each of those years. The Company may issue an additional Grant in 1998, which states that 2000 shares of A stock at \$12.50 per share will vest every April

30 starting 2001 and continuing over the next four years. The Grants will overlap so that there is always a grant in effect.

Therefore, an employee may have numerous sets of options that have different option prices and vesting periods, depending upon the Grant under which the options vested. As will be discussed below, this will affect the cost basis of the stock shares.

The value² of the option is determined by comparing the option price to the market value of the stock. If the market value is less than the option price, the option is worthless unless the value of the stock goes up. If the market value exceeds the option price, the option has a value. In that situation, the option price becomes, in effect, an opportunity to purchase the full value of the stock at a discount.

The greater the market value of the stock in excess of the option price, the greater the option value. Therefore, many employees will not exercise their options upon vesting if they believe the market price will go higher before the option expires.

The more the market value exceeds the option price, the greater the tax consequences about which you need to be concerned.

Types of Options

Options are either Qualified or Nonqualified. This is important in understanding the different tax treatment.

Qualified Options are established by an employer in conformity with USCA 26, Section 422, and 424.³ Almost all Qualified options granted after 1986 are Incentive Stock Options (Section 422, formerly Section 422A until revised in 1990).

Nonqualified Options are not intended to conform with the Internal Revenue Code requirements for the preferential tax treatment accorded Qualified options.

Each group of options, qualified and nonqualified, carries different tax consequences.

Tax Aspects of Options

1. Qualified Stock Options

Options are qualified if established according to the conditions set forth in the Internal Revenue Code Sections. Most grants will describe the type of options that are being granted.

Qualified options under IRC Section 422 are called Incentive Stock options. They have the following characteristics: Section 422 options are not exercisable after ten years from the date granted, the grantee does not own stock conferring more than 10% of the total combined voting power of all classes of stock at the time the options are granted, the options are granted within ten years from the date the option plan is adopted, and no disposition is made of the stock within two years from the date of grant or within one year after the exercise of the options.

Incentive Stock Options (ISOs) are not transferable by the employee, except upon death, and, during the lifetime of the grantee, the options may only be exercised by the grantee.

ISOs require that an employee be employed during the period beginning with the date of grant up through the day three months before the date of exercise.

In order to qualify as an ISO, the option price may not be less than the fair market value of the stock at the time of the grant.

The grant of qualified options is not a taxable event.

The exercise of qualified options is not a taxable event in the sense that it does not create ordinary income. However, exercise of options that have a market value in excess of the option price creates tax preference income for purposes of the alternative minimum tax. The calculation or existence of such a tax will depend upon the other income and deductions of the taxpayer.

As an example, Ms. Jones exercises 2000 options and purchases Z Corp. Stock for \$10 per share when the stock is trading at \$100 per share. Merely acquiring, but not selling, the stock has triggered tax preference income of \$180,000 ($2000 \times \$100 = \$200,000 - \text{exercise price of } \$20,000$), which, depending upon Ms. Jones' other income and deductions, may result in an alternative minimum tax of up to \$62,000 (28% federal, 6.65% state). Clearly, consultation with an accountant is necessary to determine tax exposure.

If Ms. Jones has no alternative minimum tax, she may hold the stocks acquired for the requisite holding period and receive preferential tax treatment when the stocks are sold. This is the benefit of qualified options as opposed to nonqualified options. She will have exercised the options free of tax. At the time the stocks are sold, Ms. Jones will have a capital gains tax (and not an ordinary income tax) to pay on the difference between the market value at time of sale and the option price. The option price becomes the cost basis for purposes of making this calculation. Under this scenario, supposing Ms. Jones sells her stocks @ \$200 per share 14 months after exercise of her options, she will pay a capital gains tax on \$380,000 ($2000 \text{ shares} \times \$200 = \$400,000 - \text{cost basis @ } \$20,000$).

On the other hand, even if no alternative minimum tax is due, if the stocks are sold immediately instead of held for one year, Ms. Jones will create \$180,000 of ordinary taxable income ($2000 \text{ shares} \times \$100 - \text{cost @ } \$20,000$). In other words, if the options are exercised and the stocks sold right away, the qualified options are treated as if they are nonqualified options and the preferential tax treatment (capital gain) is forfeited.

The preferential tax treatment accorded ISOs will be forfeited in part if the total purchase cost (option price \times option shares) of ISOs vesting in any one calendar year exceeds \$100,000. Only the first \$100,000 options to vest in a calendar year will allow the employee to enjoy the benefits described above. The excess will be treated as nonqualified options. Suppose there are two overlapping grants in effect with two vesting dates in one year, and in the same year \$75,000 of options are vesting under the earlier grant and \$125,000 of options are vesting under a later grant. The \$75,000 of options under the earlier grant and \$25,000 of options from the later grant will be accorded the ISO favorable tax treatment. The remaining \$100,000 of options will be treated as nonqualified options.

On the other hand, an employee can permit vested options to accumulate without disqualifying the options. For example, if an employee allows 100,000 options to vest each year and go unexercised, thus accumulating 400,000 options, she may exercise all of the accumulated options in one year and retain the tax advantages of qualified options.

The tax will be due for the year in which the options are exercised if there is an alternative minimum tax. Ordinary income tax will be due for the year in which the stocks are sold if they are sold less than two years from grant date or less than one year after exercise of the options. A capital gains tax will be due for the year in which the stocks are sold if the stocks are sold less than two years from grant date or less than one year after exercise of the options.

2. Nonqualified Stock Options

Nonqualified stock options are taxable at the time of grant if the options have a readily ascertainable fair market value. (Regs. Section 1.83-1(a) and -7(a))

The options seldom have a readily ascertainable fair market value because they would otherwise have to meet the following conditions: The option is transferable, exercisable immediately upon being granted, there are no conditions or restrictions that would have a significant effect on the fair market value, and the fair market value of the option privilege must be readily ascertainable. (Regs. Section 1.83-7(b)(2) and (b)(3))

Most nonqualified options will not meet the above requirements. The grant of nonqualified options that do not have a readily ascertainable value does not create a tax. However, the exercise of the option creates an immediate gain that is taxed as ordinary income less the cost of acquiring the stock. If the stock increases in value after its acquisition, the increase is taxed as a capital gain.⁴

As an example of the above, Ms. Jones' exercise of her options would result in ordinary income of \$180,000 during the year of exercise. If the stocks increased in value to \$110 per share and were then sold by her, she would realize capital gain of \$20,000 ($2000 \text{ shares} \times \10), the cost basis being the option price plus the market value at time of exercise ($\$200,000 = 2000 \text{ shares @ } \$10 \text{ per share with market value @ } \100 per share).

It should be remembered that qualified options may become nonqualified options under the circumstances discussed above. In that event, the rules pertaining to taxation of nonqualified options will be applied to those Incentive Stock Options.

3. Problems upon Division

Inasmuch as the tax is frequently triggered by the employee's exercise of the option, the transaction is reported under the social security number of the employee. Since the options are usually non-transferable, dividing the options upon dissolution creates a dilemma for the employee at such time as the non-employee wants to direct the exercise of the options allocated to him/her.

How can division be accomplished with secured indemnification to the employee who may have a substantial taxable income/gain to report?

The increased use of stock options has outpaced this area of law and taxation. In their non-transferability from the employee and their qualification under federal tax law, options are similar to qualified retirement benefits. Therefore, the logical answer to allocation upon divorce would be the creation of a QDRO for stock options. There needs to be provision for segregation and allocation of community property options upon dissolution without disturbing the tax benefits associated with qualified options, in part, defined as non-transferable.

Currently, practitioners do not have the option of a QDRO to segregate a non-employee's share of options. Therefore, we are left to the careful drafting of Marital Settlement Agreements to establish a method of allocating the non-employee's interest without jeopardizing the employee's finances.

4. Proposed Language

Frequently, options are exercised accompanied by a "same day sale" of the resulting stocks. Thus, a tax is created upon exercise of the options. Ordinary income is created because the stocks were not held for one year prior to sale. In the absence of a "same day sale," an alternative minimum tax may be created through the mere exercise of the options. Therefore, suggested language for an agreement would be as follows:

- 4.1 The community has an interest in two [stock option grants][stock option contracts], one dated _____, [grant number 1234] (hereinafter the "first grant"), and one dated _____, [grant number 5678](hereinafter the "second grant").
- 4.2 The community has an interest in 2000 options under the first grant. Those options have an option price of \$10.00 per option.
- 4.3 The community has an interest in 3000 options under the second grant. Those options have an option price of \$15.00 per option.
- 4.4 [All of the options have vested] or [All of the options under the first grant have vested, 2000 of the options under the second grant have vested, and the remaining 1000 will vest on _____, 19__.]
- 4.5 Wife (employee spouse) will hold 1000 options from the first grant and 1500 options from the second grant [in trust for Husband] [for the benefit of Husband] [for Husband] (non-employee spouse).
- 4.6 Wife may not exercise, sell, hypothecate, encumber or in any other manner dispose of, or attempt to dispose of, any options allocated to Husband under the terms of this Agreement. Wife may not devise, place in trust, or attempt to dispose of options allocated to Husband in any testamentary instrument. In the event Wife's testamentary instrument appears to attempt to devise options allocated to Husband, the terms of this Agreement shall supersede any such instrument.⁵
 - a. Should Wife violate the proscriptions set forth in Paragraph 4.6, she shall be liable to Husband for any and all losses attributable to the disposition of his stock. The first asset to which the Court shall look to make Husband whole will be any options allocated to Wife or belonging to Wife as her separate property. In the absence of available options to cure the effect of Wife's violation of this Agreement, the Court may determine the value of the loss to Husband and

order Wife to compensate Husband from any source the Court deems appropriate.

- 4.7 At this time, the options are non-transferable and must remain in the name of Wife. However, if the non-transferability of the options is ever modified so that the options may be placed in the name of Husband without consequence and in conformity with then existing restrictions, Wife and Husband shall cooperate to immediately thereupon transfer title to the options into Husband's name according to the procedure set forth by employer/issuer/grantor for transfer of title to occur.

[exercise of options only]

- 4.8 Husband will notify Wife when he wants the options exercised by written notice to Wife. The written notice will specify the following: the date upon which the options are to be exercised, the number of options to be exercised on that date, and the identity of the options to be exercised as to option price and grant number. Contemporaneous with the notice to Wife, Husband shall provide (1) the funds necessary for exercise of the options and (2) the funds necessary for payment of any alternative minimum tax possibly triggered by exercise of the options calculated at Wife's highest possible tax by Wife's tax preparer at Husband's expense. Wife shall place the funds to pay any such taxes in an interest-bearing escrow account to be used at the time the taxes are to be paid. At the time that taxes are paid, any accrued interest along with any unused funds shall be paid over to Husband. Wife shall be relieved of any liability for failure to exercise the options as directed if the funds for exercise and/or the funds for taxes are not forwarded at the time of notice to Wife. Despite the return of any unused funds and interest to Husband upon payment of taxes by Wife, Husband shall remain liable for holding Wife harmless from and fully indemnifying Wife for any and all taxes related to exercise of options allocated to Husband.
 - a. Immediately upon exercise of the options and issuance of the resulting stocks, Wife shall have transferred into Husband's name all of the said stock if:
 1. Transfer of title is permitted by issuer.
 2. Such transfer is not prohibited by any applicable law, statute, restriction, or agreement between Wife and employer or issuer.
 - b. Each of the parties will cooperate in executing any document(s) reasonably necessary to effectuate the transfer referred to in subpart a. of this Paragraph 4.8.
 - c. The Court will retain jurisdiction to implement and enforce the transfer of title.
 - d. Transfer of title to the stocks shall constitute a transfer under Internal Revenue Code Section

1041. Should any taxing authority contest the qualification of the transfer under Section 1041, both of the parties shall cooperate in providing the authority with any testimony, statements, or documentation consistent with the terms of this agreement. Should the transaction be disallowed as a transfer between spouses incident to divorce under IRC Section 1041, Husband shall be solely responsible and forever hold Wife free and harmless and fully indemnify Wife from any liability for such taxes [including any interest or penalties thereon] and [the Court shall retain jurisdiction to allocate between the parties any responsibility for interest and penalties thereon]. or

[options exercised/stocks sold immediately]

4.9 Husband will notify wife when he wants the options exercised by written notice to Wife. The written notice will specify the following: the date upon which the options are to be exercised, the number of options to be exercised on that date, and the identity of the options to be exercised as to option price and grant number. If Husband wishes to exercise the options but cannot provide the funds to do so, Husband may direct Wife to exercise the options and sell so much of the resulting stock as is necessary to pay for the exercise and all taxes that could be owed as a result of the exercise of the options and the sale of the stock. The potential taxes will be calculated at Wife's highest possible tax rate by Wife's tax preparer at Husband's expense.⁶ The proceeds from the sale equivalent to the potential taxes shall be placed in an interest-bearing escrow account to be used at the time the taxes are to be paid. At the time that taxes are paid, any accrued interest along with any unused funds shall be paid over to Husband. Despite the return of any unused funds and interest to Husband upon payment of taxes by Wife, Husband shall remain liable for holding Wife harmless from and fully indemnifying Wife for any and all taxes related to the exercise of options allocated to Husband.

a. Husband may not direct Wife to exercise the options by margining the resulting stock account without the immediate sale of stock as described herein above.

4.10 Wife has no obligation to comply with the notified direction to exercise the options if Husband does not cooperate in compliance with one of the foregoing two choices.

[Assignment of Taxes]

4.11 If the parties agree to do so in writing, allocation of taxes resulting from exercise of the options may be accomplished in the following manner, to wit: Husband shall abide by the notification requirements set forth above respecting the exercise of options or the "same day sale" of options and stocks. Husband will not have an obligation to provide

contemporaneously funds for anticipated taxes resulting from the transactions because the parties agree as follows:

- a. Each party who receives any shares of stock or the proceeds from sale of such stock shall be solely liable and forever hold the other free and harmless from any liability for and fully indemnify the other for any taxes, federal or state, that are attributable to the exercise of options or sale of stocks.
- b. Any taxable transaction reported under Wife's social security number that is attributable to Husband's options or resulting stocks shall be deducted from Wife's income tax returns and shall be reported by Husband on his tax returns under his social security number or other tax identification number.
- c. The parties shall execute a statement to be attached to each party's income tax returns informing the taxing authority of the deduction from Wife's and inclusion in Husband's tax returns of the options/stocks transactions.
- d. If there has been any withholding of income taxes from proceeds of exercise or sale, Husband shall be entitled to credit for the withholding to the extent that Wife is legally able to transfer the taxable transaction from her tax returns to Husband's tax returns.

4.12 In the event the procedure set forth above is not allowed by any taxing authority, Husband shall be immediately liable to Wife for the entire taxes attributable to the transactions on his options/stocks, less any taxes actually withheld.

4.13 Should additional taxes be owed as a result of the exercise of the options directed by Husband at any time after the taxes have originally been paid and any unused funds or interest has been returned to Husband, Husband shall forthwith transfer to Wife the amount necessary for the additional taxes. If insufficient funds are available to do so, Husband shall allocate to Wife some of his unexercised options or unsold stock to satisfy the tax obligation. The options/stocks allocated back to Wife shall cover the taxes owed as well as any taxes that will be triggered by the necessity of having to sell those options or stocks to meet the tax obligation. The number of options or stocks that shall be allocated back to Wife shall be determined by an accountant or other expert of Wife's choice. If no options or stock are available, the Court may order payment by Husband from any source the Court deems appropriate.

- a. [The Court will retain jurisdiction to allocate responsibility for the services rendered by Wife's tax preparer or other expert] [The parties will equally share the cost of services rendered by Wife's tax preparer or other expert] [Wife/Husband will bear the costs of services ren-

dered by Wife's tax preparer or other expert] in determining the number of options or stocks to be transferred back to Wife, *or*

- 4.14 Husband or Husband's designated agent shall have the right to confer with Wife's tax preparer regarding the calculation and determination of any taxes claimed to be owed as a result of the delegated exercise of the options.
- 4.15 Wife shall provide Husband with documentation of compliance with his notice to exercise the options, documentation of the calculation of the taxes owed, and any and all information pertaining to the determination of the cost basis of the stock or cost of exercising the options. Nothing in this section shall constitute a waiver of the confidentiality of Wife's income tax returns. The obligation to provide documentation does not include an obligation to provide Husband with a copy of any of Wife's income tax return(s).
- 4.16 Wife shall provide Husband with any information she receives pertaining to the options that are the subject of this agreement, including modifications of the underlying grant and notifications regarding value or expiration. This information shall be forwarded to Husband within a reasonable time of receipt by Wife. Husband shall keep Wife informed of an address to which he wants such information sent.
- 4.17 Wife's employer shall be provided with a copy of the terms of this Agreement that pertain to the division of stock options. Wife shall forthwith advise Husband of the name, address, telephone number, or facsimile number of the individual(s) responsible for implementation of the options benefit on behalf of Wife's employer.

5. The Court Reserves Jurisdiction to:

- 5.1 Resolve any disputes between the parties related to implementation of the stock option portion of this Marital Settlement Agreement, inclusive of all provisions on that subject.
- 5.2 Allocate between the parties the responsibility for any interest or penalties assessed by any taxing authority resulting from any transaction by Wife in conformity with Husband's notification.
- 5.3 Allocate the costs of any professionals employed in connection with the additional assessment of taxes;
- 5.4 Implement and enforce the terms of this Marital Settlement Agreement pertaining to the exercise of stock options, inclusive of all provisions on that subject;
- 5.5 Resolve any problems arising where either party's failure to exercise options may prevent or is preventing the other from exercising subsequent options.

- 5.6 Insure the proper characterization and division of community property options in any restated reissued stock option and any stock option that is designed to provide dilution protection to any community property option.

6. Notice to Husband

- 6.1 Exercise of the options may trigger a tax that will be immediate and specific and due from you to Wife at the time of notice to exercise.
- 6.2 Sale of the stock prior to expiration of the one-year holding period, beginning with the day after exercise, will result in an income tax on the gain in value of the stock since date of grant.⁷ Should the stocks be non-transferable during the holding period, Wife shall be entitled to place in escrow proceeds from sale of the stock sufficient to meet any tax obligation on the sale of the stock, which taxes shall be calculated at the Wife's highest possible rate calculated by Wife's accountant or tax preparer. The procedure relating to these funds and your obligation to hold harmless and indemnify shall be the same as stated herein in relation to the taxes upon exercise of the options. If the stock has been transferred into your name during the holding period, the sales transaction will be reported under your social security number and it will be your obligation to report the transaction on your individual tax returns for year of sale.
- 6.3 Failure to exercise the options on or before _____ will result in expiration of the options, which shall immediately thereupon be of zero value and cease to be an asset or interest of any value to you.
- 6.4 Failure to exercise the option could result in a loss of its value as an asset if the market value of the stock goes below the option price of the option.
- 6.5 Wife has no duty under the terms of this Agreement or as a fiduciary or agent of yours to exercise the options if you do not comply with every provision set forth above in either paragraph 4.6 or paragraph 4.7 or she does not agree to the procedure set forth in paragraph 4.11 and its subparts.
- 6.6 Wife has no liability for failure to exercise options requested by you if you give proper notice and provide the tax monies as prescribed if Wife is prevented by issuer, employer, or any terms or provisions of the Grant or a revised version of the subject Grant or if prohibited by any regulation, law, or other mandate.
- 6.7 You cannot direct the exercise of options that have not vested at the time of notice to exercise options. In order to exercise the options, the options must be vested. The options that are not vested at the time of this agreement will vest on _____, on condition that Wife is employed with employer on that date. [If Wife is not employed on that date for any reason and those

options do not vest, their allocation under this Agreement is moot. Wife has no obligation to you, for any reason or under any theory, if she is not employed on that date for any reason, thereby causing the options not to vest. [You hereby waive any right to make any claim against Wife in the event she is not employed, for any reason, on the scheduled vesting date, thereby forfeiting the vesting of those options.]

- 6.8 Your obligation to pay taxes created by the exercise of the options is absolute and includes any taxes claimed by any taxing authority in the event the options are held to be non-qualified. In that case, your obligation to pay taxes, hold Wife harmless, and fully indemnify her is unchanged, although the tax liability may be greater than anticipated had the options qualifications under applicable Internal Revenue Code sections been upheld.

The above guidelines should provide some ideas about accommodating the peculiarities of allocating stock options. Appropriate variations on the above language should be made to meet the differences that arise if the options are non-qualified or have some other distinct characteristic special to the case.

As an example, non-qualified options may be transferable. If the options are transferable, nearly all of the problems identified in the proposed language are obviated. (Remember, non-qualified options may trigger a tax upon grant.)

Conclusion

Options are a complex and increasingly common asset in marital estates. It is important to carefully review the Grant documents to determine questions of characteriza-

tion and allocation. It is equally important to understand the type of options in order to anticipate seemingly hidden, but potentially costly, tax consequences. Consultation with a knowledgeable accountant is the best way of insuring that the taxes are accounted for and not overlooked in the division of property.

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Endnotes

1. It is true that some employers with closely held, non-publicly traded stock allow certain employees to acquire options or shares. If in the form of options, those will usually be non-qualified. Non-qualified options are discussed in this article; however, the general definition that I give pertains to the majority of options we will encounter, on publicly traded stock shares.
2. "Value" as used is not intended to mean the forensic value of the option, but its status as an asset.
3. Section 423 pertains to Employee Stock Purchase Plans, with which this article is not concerned.
4. If the stock decreases in value, the decrease is treated as a capital loss.
5. If options have been exercised, stocks acquired, but the stock ownership has not been transferred to Husband, language should be drafted to restrain the disposition of the stock shares rightfully belonging to Husband.
6. With a "same day sale," the stock transaction will be reported under the employee's social security number. Frequently, taxes will automatically be withheld upon sale of the stock. In that event, allowance for the withholding should be made in calculating the amount of money that non-employee has to transfer to employee to comply with the conditions for exercise of the non-employee's options.
7. The proscription on disposal of the stock during the holding period does not include transfer of title into the name of the non-employee spouse. (See USCA 26, Section 424(c)(4)).