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DEPARTMENT OF THE TREASURY
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MEMORANDUM FOR

FROM: DEBORAH A. BUTLER
Assistant Chief Counsel (Field Service)
CC:DOM:FS

SUBJECT: Taxability of Stock Options

This Field Service Advice responds to your memorandum dated July 29, 1999. Field Service Advice is not binding on Examination or Appeals and is not a final case determination. This document is not to be cited as precedent.

LEGEND:

husband =
ex-wife =
Date =
State =
Company =
a =
Year =

ISSUE:

Whether husband is taxed under I.R.C. § 83 when stock options are transferred to his ex-wife pursuant to a divorce decree or when they are exercised by his ex-wife.

CONCLUSION:

Husband is taxed under section 83 at the time of the transfer of options to ex-wife. Ex-wife receives a carryover basis in the options under section 1041(b). Ex-wife's tax consequences upon the ultimate disposition of the stock would be governed by section 1001. Thus, neither husband nor ex-wife is taxed under section 83 when the options are exercised by ex-wife.

FACTS:

Pursuant to the Judgment of Dissolution of Marriage (divorce decree) entered on Date, husband and ex-wife's marriage was dissolved and their property was divided. At the time of the divorce decree, they were State residents.

During the marriage, husband was employed by Company, and he was awarded *a* incentive stock options and nonqualified stock options by Company. Pursuant to the divorce decree, wife was awarded half of the *a* options.[1]

In Year, ex-wife exercised the options she received pursuant to the divorce decree. For Year, Company issued husband a Form 1099 in which the difference between the fair market value of the stock and the exercise price paid by ex-wife was reported. Husband included this gain on his Federal income tax return for Year and has filed a claim for refund of the tax related to the gain.

LAW:

Under section 83(a), if, in connection with the performance of services, property is transferred to any person other than the service recipient, the excess of the fair market value of the property, on the first day that the rights to the property are either transferable or not subject to a substantial risk of forfeiture, over the amount paid for the property, is included in the service provider's gross income for the first taxable year in which the rights to the property are either transferable or not subject to a substantial risk of forfeiture.

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[1] Because of the rules prohibiting transfer of incentive stock options, when the incentive stock options were transferred to ex-wife pursuant to the divorce decree they became nonqualified stock options taxable under section 83. See section 422(a) of the Code.

Under section 83(e), section 83 does not apply to a transaction to which section 421 applies or to the transfer of an option without a readily ascertainable fair market value.

Treas. Reg. § 1.83(a)-7(a) provides rules for options to which section 421 of the Code does not apply and that do not have a readily ascertainable fair market value at the time of the grant. Under those rules, sections 83(a) and 83(b) apply at the time the option is exercised or otherwise disposed of, even though the fair market value of such options may have become readily ascertainable before such time. If the option is sold or otherwise disposed of in an arm's length transaction, sections 83(a) and 83(b) apply to the transfer of money or other property received in the same manner as sections 83(a) and 83(b) would have applied to the transfer of property pursuant to the exercise of the option.

Under Treas. Reg. § 1.83-1(b)(1), if substantially nonvested property (that has been transferred in connection with the performance of services) is subsequently sold or otherwise disposed of to a third party in an arm's length transaction while still substantially nonvested, the person who performed such services realizes compensation in an amount equal to the excess of the amount realized on such sale or disposition, over the amount (if any) paid for such property. Such amount of compensation is includible in gross income in accordance with the person's method of accounting.

Under Treas. Reg. § 1.83-1(c), if substantially nonvested property is disposed of in a transaction which is not at arm's length and the property remains substantially nonvested, the service provider realizes compensation equal in amount to the sum of any money and the fair market value of any substantially vested property received in such disposition. Such amount of compensation is includible in gross income in accordance with the service provider's method of accounting. However, such compensation shall not exceed the fair market value of the property disposed of at the time of disposition (determined without regard to any lapse restriction), reduced by the amount paid for such property. In addition, section 83 shall continue to apply with respect to such property, except that any amount previously includible in gross income under this paragraph shall be treated as an amount paid for such property.

Although not explicitly stated in Treas. Reg. § 1.83-7(a) of the regulations, we see no reason why the rules in Treas. Reg. §§ 1.83-1(b) and (c) regarding arm's length and non-arm's length dispositions of restricted stock should not apply to compensatory options. Just as is the case with compensatory restricted stock and dispositions prior to vesting, if a compensatory option is disposed of in an non-arm's length transaction, the service provider is taxed on any amount received on the disposition of the option and again on the exercise of the option. Conversely, if the disposition is arm's length, section 83 does not apply to the property transferred on exercise of the option.

Section 1041(a) provides that no gain or loss shall be recognized on a transfer of property between spouses and former spouses if the transfer is incident to divorce. The property shall be treated as acquired by the transferee by gift, and the basis of the transferee in the property shall be the adjusted basis of the transferor. Section 1041(b).

The assignment of income doctrine, first articulated in Lucas v. Earl, 281 U.S. 111 (1930), holds that a taxpayer who possesses a current or future right to receive income cannot shift the tax on such income by transferring the right to receive income to another taxpayer. Thus, income is taxable to the taxpayer who earns and controls it. Id. The choice of the proper taxpayer revolves around the question of which person or entity in fact controls the earning of income rather than who ultimately receives the income. See Vercio v. Commissioner, 73 T.C. 1246 (1980).

ANALYSIS:

In this case, Company transferred both incentive stock options and nonqualified stock options to husband in connection with his performance of services for Company. Pursuant to the divorce decree, ex-wife received one half of those options. Because of the rules governing incentive stock options, the portion of the options that were incentive stock options in the hands of husband became nonqualified stock options. Therefore, section 83 governs the treatment of the options transferred to ex-wife pursuant to the divorce decree.[2]

Assuming that section 83 did not apply to the nonqualified stock options at the time they were granted to husband because they did not have a readily ascertainable fair market value, section 83 applies when the options are exercised or otherwise disposed of. Under section 83, the husband's transfer of one-half of his options to ex-wife was a disposition of those options and a taxable event, and it was also a closed compensatory transaction if the transfer was at arm's length. Compare Treas. Reg. § 1.83-1(b). If the transfer was not at arm's length, the taxable event under section 83 to husband occurred on the transfer of the options to ex-wife pursuant to the divorce decree and again when the ex-wife's exercised those options. Compare Treas. Reg. § 1.83-1(c).

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[2] See supra note 1.

The enactment of section 1041 effectively nullified the holding of United States v. Davis, 370 U.S. 65 (1962), that the transferor of stock under a divorce decree disposed of the stock for tax purposes and received taxable gain equal to the difference between the fair market value and the transferor's basis. However, Davis still stands for the proposition that the parties to the divorce exchanged the stock for the release of other marital rights or property in an arm's length transaction and that the properties exchanged were of equal value. See United States v. Davis, 370 U.S. at 71.

Generally, transactions between related individuals appear to be non-arm's length transactions. See Treas. Reg. § 1.83-1(c). In light of the Davis case, however, we believe that the transfer of the options to ex-wife was an arm's length transaction. Thus, section 83(a) applied to the transfer of money or other property received by husband in exchange for the transfer of the options, and husband received compensation income to the extent of the difference between the amount realized from the transfer to ex-wife pursuant to the divorce decree and any basis husband had in the options. Based on the Davis analysis on this point, the property husband received in exchange for the options is presumed to be equal in value to the options at the time they were transferred to ex-wife. Thus, husband received compensation income equal to the fair market value of the options when they were transferred to ex-wife pursuant to the divorce decree. When ex-wife subsequently exercised the options, there was no taxable event to husband under section 83, and there were no tax consequences to ex-wife. Rather, ex-wife should be taxed on any gain on the subsequent sale of the underlying stock, with a basis for this purpose equal to the amount includible in husband's gross income.

Thus, under section 83, the transfer of the options to ex-wife pursuant to the divorce decree (because it is a disposition of the options) resulted in compensation income to husband that was includible in his gross income at the time of the transfer. Because the transfer was an arm's length transaction, husband had no compensation income under section 83 when ex-wife exercised the options.

Although husband received compensation income equal to the fair market value of the options when the options were transferred to ex-wife, we understand husband may contend that section 1041 shields even that amount from his gross income. We believe husband's compensation income is not shielded by section 1041. Section 1041(a) provides that no gain or loss shall be recognized on a transfer of property between spouses and former spouses if the transfer is incident to divorce. Because compensation is ordinary income, and not "gain," section 1041 would not shield that income from recognition. Gibbs v. Commissioner, T.C. Memo. 1997-196 (section 1041 does not provide for the exclusion of income; it provides for the nonrecognition of gain or loss).

In cases and rulings where the Service has taken the position that section 1041 does not apply, the Service has consistently applied the assignment of income doctrine, which requires the transferor, rather than the payee, to recognize the assigned income. See Lucas v. Earl, 281 U.S. 111 (1930).

Service position on section 1041(a) versus assignment of income principles is articulated in Rev. Rul. 87-112, 1987-2 C.B. 207. The ruling holds that a taxpayer who transfers Series E and EE bonds to a former spouse must include in gross income for the year of transfer the interest on the bonds that is accrued but unrealized at the time of transfer and that the transferee's basis in the bonds must increase by a like amount. Rev. Rul. 87-112 states that although section 1041(a) shields from recognition gain that would ordinarily be recognized on a sale or exchange of property, it does not shield from recognition income that is ordinarily recognized upon the assignment of that income to another taxpayer. Because the income at issue in the ruling was accrued but unrecognized interest, rather than gain, section 1041(a) did not shield that income from recognition.

The Service based its conclusion on Treas. Reg. §1.454-1(a) (relating to taxation of government bond interest) and section 1015 (gift basis rules). Under Treas. Reg. §1.454-1(a), cash basis taxpayers are entitled to defer the tax on the annual increments in the redemption value of Series E or EE savings bonds until the taxable year in which the bonds mature, are redeemed, or disposed of, whichever occurs first. Disposition of the bonds, even by gift, triggers recognition of all the accrued interest in the year of disposition. See Rev. Rul. 54-143, 1954-1 C.B. 12 (taxpayer must recognize interest accrued on E bond when she transferred it to her daughter, whether transaction was a gift or a sale. Only interest accrued after the date of the transfer is includible in the transferee's income).

Although it could be argued Rev. Rul. 87-112 is a narrow ruling on its facts, it is significant in that it states the Service's current view that a transfer of accrued income (such as accrued interest, dividends or rent), or in the instant case, deferred compensation, to a spouse or former spouse incident to divorce remains taxable to the transferor without regard to section 1041. Thus, section 1041 would not shield recognition of husband's compensation income on the transfer of the stock options to ex-wife.

The Service has consistently followed the position set forth in Rev. Rul. 87-112. Although private letter rulings may not be cited as precedent, PLR 8813023, involving a military pension again illustrates Service position. In this ruling a divorce originally awarded the pension entirely to H because the Supreme Court had held in McCarty v. McCarty, 453 U.S. 210 (1981) that military pensions could not be treated as community property. After Congress overruled McCarty, 10 U.S.C. § 1408 (1982), the state enacted a statute providing for the reopening of divorce decrees so that military pensions could be treated as community property. H then purchased W's community interest in the pension by agreeing to pay her cash in three annual installments. The ruling held that W must include the cash in income at the time she receives it. Relying on Rev. Rul. 87-112, the Service declared W in effect assigned to H her right to receive payments over H's lifetime in exchange for payments from H over three years. W could not escape the taxation of ordinary income by recharacterizing her assignment of the income as a nontaxable transfer of property under section 1041.

PLR 8842072 also contains broad dictum stating that assignment of income principles override section 1041. The Service ruled that principal payments on a note received by W were covered by section 1041 and, thus, were not taxable to her even though the payments came from H's corporation. At the end of the ruling, the Service added that section 1041 would not apply to the extent assignment of income principles were applicable. Citing Rev. Rul. 87-112, the ruling concluded, "We express no opinion on whether the entire principal payment is property subject to section 1041 because the note may represent payment for a right to earned or accrued income that is subject to the assignment of income principle."

CASE DEVELOPMENT, HAZARDS, AND OTHER CONSIDERATIONS:

[redacted] In Balding, the only case in which the Tax Court has considered whether section 1041 or the assignment of income doctrine applies to a divorce related transfer, the court determined that section 1041 prevailed. Balding addressed the question of whether payments received by a spouse in settlement of her claim to a community property share of her ex-husband's military retirement pay were includible in her income. In Balding, taxpayer and her ex-husband resided in California, a community property state, during their 19-year marriage. They were divorced in 1981, subsequent to her ex-husband's retirement from the military. The divorce court ordered a division of their community property and affirmed that her ex-husband's military retirement pay was his sole and separate property. In 1984, because of changes in California's community property law, taxpayer asked the divorce court to reopen its judgment of divorce and award her a community property share of her ex-husband's military retirement pay. Before the divorce court could act, taxpayer and her ex-husband reached a settlement with regard to the retirement pay. Taxpayer relinquished any claim to her ex-husband's military retirement pay in consideration of her ex-husband's promise to pay to her $15,000, $14,000, and $13,000 in 1986, 1987, and

1988, respectively. The Tax Court held that, under section 1041, no income was recognized to taxpayer on account of receipt of the settlement payments.

In Balding, the Service unsuccessfully argued that the taxpayer's relinquishment of her community interest in her ex-husband's military retirement benefits in exchange for cash was an anticipatory assignment of income to the ex-husband. The court concluded that section 1041 precluded such result where the settlement payments were received by a wife in exchange for her release of any claim to a community property interest in her ex-husband's military retirement plan benefits incident to their divorce. The court noted, however, that outside the marital context, the Service's position would probably have been the correct result. Id. at 370.

Arguably, Balding could indicate the Tax Court takes the broad view that section 1041 supersedes assignment of income principles. However, the Service would argue such a conclusion is premature in light of footnote 8 of the opinion. Id. at 373. In footnote 8, the Tax Court observed that it did not have to consider in this case whether the assignment of income doctrine would require the wife to include her "share" of those benefits in income as they were paid to the ex-husband. Id.

Moreover, in Kochansky v. Commissioner, T.C. Memo. 1994-160, aff'd in part and rev'd in part, (9th Cir. 1996), the parties' property settlement agreement provided that the parties would share equally a contingent fee earned by the husband-lawyer in a medical malpractice case. The Tax Court agreed with the Service that as the fee was the husband's personal services income, the share of the fee received by the wife pursuant to the agreement was taxable to the husband under assignment of income principles.

Finally, an argument in favor of applying assignment of income to divorce arises from the regulations which provide, "Only transfers of property (whether real or personal, tangible or intangible) are governed by section 1041. Transfers of services are not subject to the rules of section 1041. Temp. Reg. § 1.1041-1T(a), A-4. Although the regulation language is limited to the transfer of services, implicit in the regulation is the concept that section 1041 does not apply to the transfer of the compensation for such services (i.e., the person performing the services is taxed on the compensation therefrom, even if it is paid by the other spouse). Arguably, this regulation indicates the assignment of income rules relating to personal services should apply to the exclusion of section 1041.

In sum, under section 83, the transfer of the options to ex-wife pursuant to the divorce decree (because it is a disposition of the options) resulted in compensation income to husband that was includible in his gross income at the time of the transfer. Because the transfer was an arm's length transaction, husband had no compensation income under section 83 when ex-wife exercised the options.

Although husband received compensation income equal to the fair market value of the options when the options were transferred to ex-wife, husband will likely contend that section 1041 shields that amount from his gross income. [redacted]

If you have any further questions, please call the branch telephone number.

By: ~~Clifford M. Harbourt~~

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