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Person To Contact:
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Telephone Number:

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PLR-130300-04

Date:
January 13, 2005

X =

Company =

E =

State =

court =

date of separation =

date of divorce =

judgment date =

Plan =

a options =

Dear :

This letter is in response to your request dated May 27, 2004, requesting rulings under sections 56, 422, 424, 1041, and 2501 of the Internal Revenue Code as they relate to the division of stock options in a property settlement agreement incident to divorce. You requested rulings that the division of certain nonqualified and statutory stock options will not be taxable and will not disqualify any of the statutory options; that upon exercise of X's nonstatutory and statutory options, X will include any resulting income in calculating X's gross income with respect to the nonstatutory options and alternative minimum tax with respect to the statutory options; that when any of the stock received on exercise is sold, any resulting income, gain or loss will be taxable to X; and that the division will not result in taxable gifts between X and X's former spouse, E; that, upon E's death (should X survive E), X may exercise X's share of the statutory options without disqualifying them; and that, with respect to any income arising from this transaction that is "wages," the income tax withholding credits will flow to the party receiving the underlying wages.

The facts, as submitted, are as follows. During X and E's marriage, E was employed at Company and they resided in State, a community property state. Their marriage was dissolved by a judgment entered by the court and effective on the date of divorce.

Prior to the date of separation, Company granted nonstatutory and statutory options (collectively, options) to E under the Plan. Some of the options vested prior to the date of separation, some of the options vested after the date of separation, and some of the options remain unvested. Under section 7 of the incentive stock option (ISO) agreement, ISOs may not be transferred other than by the laws of descent and distribution, and may, during E's lifetime, only be exercised by E. Under section 7 of the nonstatutory option agreement (NSO), the NSOs may be exercised only by E or by a transferee under a qualified domestic relations order. The NSOs did not have a readily ascertainable fair market value on the date of grant.

The division of most of the marital estate was resolved by a series of orders by the court and agreements between E and X. However, due to disputes concerning the appropriate method to divide the unexercised options, the court reserved jurisdiction over all unresolved issues. After negotiations over the division of the options, E and X entered into a binding written stipulation (the Stipulation) that X would receive a options proportionally distributed over the grants in dispute if, and when, they become vested pursuant to the Plan. The allocation of the options was based on the time rule, a fraction that generally compares (i) the length of the period between the date of grant of each option and the date of separation to (ii) the length of period between the date of grant and the vesting date of each tranche[1] within each option grant.

The Stipulation designates E's attorney to prepare a formal judgment on reserved issues (JRI) implementing the agreed allocation of the options. The JRI provides that X's ISOs will remain in E's name, but that X will retain all legal and beneficial ownership of X's ISOs to the extent consistent with the nontransferability and employee exercise rules of section 422(b)(5) of the Code. The JRI also provides that X's NSOs, including unvested NSO's subject to the same vesting schedule, will be fully transferred to X, as permitted by Company and the Plan. E will exercise X's ISOs (and any of X's NSOs remaining in E's name) only according to X's written instructions and only on X's paying or making acceptable arrangements for the payment of the exercise

[1] Tranche refers to each portion of an option grant that vests periodically (e.g., monthly, quarterly, or annually) between the date of grant and the final vesting date for the grant.

price and all costs of the transaction. Unless the stock subject to these options is to be immediately sold, it will be transferred directly to X upon exercise. The income and employment taxes attributable to this stock will either be paid by X or paid by the withholding of shares. If the stock is immediately sold, the proceeds of the sale will be transferred directly to X or to X through E, net of any applicable withholding taxes and expenses of sale. The JRI requires E to designate X as beneficiary of X's options under the beneficiary designation procedures of the Company and the Plan and in E's own estate planning documents. E is required to reimburse X for any withholding of employment taxes that are subject to wage base or similar limits. X and E are required to reimburse each other if one is taxed on income or credited with tax payments that should be taxed to or credited to the other, and they are unable to rectify this by appropriate adjustments on their tax returns. The court formalized the JRI consistent with the terms described in the previous paragraph on the judgment date.

Under State law, the interests of E and X in community property during marriage are present, existing, and equal interests. Generally, under State law, property acquired by a married person during marriage is community property.

Community property earned through the efforts of one spouse is considered to be owned by the community from the time of acquisition. Poe v. Seaborn, 282 U.S. 101 (1930). The services of one spouse are considered to be rendered by the community, that is equally by each of the spouses. Graham v. Commissioner, 95 P.2d 174 (9th Cir. 1938).

Section 83(a) of the Code provides, in general, that if property is transferred to any person in connection with the performance of services, the excess of the fair market value of the property over the amount, if any, paid for the property is included in the gross income of the person performing the services in the first taxable year in which the rights of the person having the beneficial interest in such property are transferable or are not subject to a substantial risk of forfeiture, whichever is applicable.

Section 83(e) of the Code provides that section 83 does not apply to the transfer of an option without a readily ascertainable fair market value.

Section 1.83-7(a) of the Income Tax Regulations provides rules for nonstatutory options. Under those rules, if the option does not have a readily ascertainable fair market value on the date of grant, then sections 83(a) and (b) apply at the time the option is exercised or otherwise disposed of, even though its fair market value may have become readily ascertainable before that time. If the option is exercised, sections 83(a) and (b) apply to the transfer of property pursuant to the exercise, and the employee realizes compensation on the transfer at the time and in the amount determined under sections 83(a) or (b).

With respect to statutory stock options, section 421(a) of the Code provides that if a share of stock is transferred to an individual in a transfer in respect of which the requirements of section 422(a) or 423(a) are met, then no income results at the time of the transfer of such share to the individual on exercise of the option, and no deduction under section 162(a) is allowable with respect to the transfer of such share.

Section 422(a) of the Code provides, in part, that section 421(a) applies with respect to the transfer of a share of stock to an individual pursuant to the exercise of an ISO if no disposition of such share is made by the individual within two years from the date of the granting of the option or one year after the transfer of the share to the individual.

Under section 424(c)(1) of the Code, a disposition includes a sale, exchange, gift, or a transfer of legal title (with certain exceptions described in section 424(c)(1)). Under section 424(c)(4), in the case of any transfer described in section 1041(a), such transfer shall not be treated as a disposition of the stock for purposes of section 424, and the same tax treatment with respect to the transferred property shall apply to the transferee as would have applied to the transferor.

Section 1041 of the Code provides, in part, that no gain or loss shall be recognized on a transfer of property from an individual to a former spouse, but only if the transfer is incident to the divorce. Incident to divorce is defined in section 1041(c) as a transfer of property within one year after the date on which the marriage ceases or a transfer of property that is related to the cessation of the marriage.

The term related to the cessation of the marriage is explained in Question and Answer 7 in section 1.1041-1T(b) of the regulations. Under the regulation, a transfer of property is treated as related to the cessation of the marriage if the transfer is pursuant to a divorce or separation instrument, as defined in section 71(b)(2), and the transfer occurs not more than six years after the date on which the marriage ceases.

The regulation further provides that any transfer occurring more than six years after the cessation of the marriage is presumed to be not related to the cessation of the marriage. However, this presumption may be rebutted only by showing that the transfer was made to effect the division of property owned by the former spouses at the time of the cessation of the marriage.

Question and Answer 7 in section 1.1041-1T(b) of the regulations also provides an example whereby the presumption may be rebutted by showing that the transfer was not made within the one and six-year periods because of factors which hampered an earlier transfer of the property, such as legal or business impediments to transfer or disputes concerning the value of the property owned at the time of the cessation of the marriage, and the transfer is effected promptly after the impediment to transfer is removed.

In Rev. Rul. 2002-22, 2002-1 C.B. 849, A and B resided in a non-community property state. During the marriage, Corporation Y granted NSOs to A. Pursuant to the property settlement incorporated into their divorce, A transferred to B one-third of the NSOs issued to A. The ruling concludes that the interests in the NSO's that A transfers to B are property within the meaning of section 1041. Section 1041 confers nonrecognition treatment on any gain that A may otherwise realize when A transfers this interest to B. A is not required to include in gross income any income resulting from B's exercise of the NSOs. When B exercises the NSOs, B must include in income an amount determined under section 83(a) as if B were the person who performed the services. The ruling further provides that the same conclusions would apply if A and B resided in a community property state and all or some of these income rights constituted community property that was divided between A and B as part of their divorce. Therefore, the ruling holds that a taxpayer who transfers interests in NSOs to a former spouse incident to divorce is not required to include an amount in gross income on the transfer. It further holds that the former spouse, not the taxpayer, is required to include an amount in gross income when the former spouse exercises the NSOs.

Rev. Rul. 2002-22 also concludes that the transfer of a statutory option to a spouse in connection with a divorce results in the disqualification of the option under sections 422(b)(5) and 423(b)(9). Thus, if an option is transferred in connection with a divorce, that option is disqualified and thereafter treated in the same manner as a NSO.

Pursuant to the JRI, certain NSOs held by the community will be fully transferred to X, and certain ISOs will remain in E's name, but X will be considered the beneficial owner of certain of those ISOs remaining in E's name. The fact that E exercises the ISOs on X's behalf and that X's portion of the ISO's remains in E's name, as required under the ISO agreement, does not violate the transferability or exercisability requirements of section 422(b)(5). Additionally, when X's ISOs are later exercised and the stock is transferred to X, there is no disposition of the stock. However, on subsequent disposition of the ISO stock (assuming the holding period requirements have been met), capital gain or loss will be recognized by X with respect to the stock received on exercise of X's ISOs. Pursuant to section 1041, Rev. Rul. 2002-22 and community property law, the transfer of the NSOs to X will not be treated as a disposition of those options and X must report the compensation income under section 83(a) of the Code when those options are exercised.

Section 31(a)(1) of the Code provides that the amount withheld as tax under chapter 24 (Collection of Income Tax at Source on Wages) shall be allowed to the recipient of the income as a credit against the tax imposed by this subtitle (Subtitle A, Income Taxes).

Section 31(a)(2) of the Code provides that the amount withheld under Chapter 24 shall be allowed as a credit for the taxable year beginning in such calendar year. If more than one taxable year begins in a calendar year, such amount shall be allowed as a credit for the last taxable year so beginning.

Section 1.31-1(a) of the regulations provides as follows:

The tax deducted and withheld at the source upon wages under chapter 24 of the Internal Revenue Code … is allowable as a credit against the tax imposed by subtitle A …upon the recipient of the income. If the tax has actually been withheld at the source, credit or refund shall be made to the recipient of the income even though such tax has not been paid over to the Government by the employer. For the purpose of the credit, the recipient of the income is the person subject to tax imposed under subtitle A upon the wages from which the tax was withheld. For instance, if a husband and wife domiciled in a State recognized as a community property state for federal tax purposes make separate returns, each reporting for income tax purposes one half of the wages received by the husband, each spouse is entitled to one-half of the credit allowable for the tax withheld at source with respect to such wages.

The alternative minimum tax is imposed by section 55 of the Code. The alternative minimum tax is the excess (if any) of the tentative minimum tax for the taxable year over the regular tax for the taxable year.

For individuals, the tentative minimum tax for the taxable year is the sum of 26 percent of so much of the taxable excess as does not exceed $175,000, plus 28 percent of so much of the taxable excess as exceeds $175,000. The taxable excess is so much of the alternative minimum taxable income for the taxable year as exceeds the exemption amount.

For taxpayers filing a joint return in 2004 the exemption amount is $58,000. The exemption amount may be phased out under the provisions of section 55(d)(3) of the Code if a taxpayer's alternative minimum taxable income exceeds certain amounts.

Alternative minimum taxable income is the taxable income of the taxpayer for the taxable year determined with the adjustments provided in sections 56 and 58 and increased by the amount of the items of tax preference described in section 57.

Section 56(b) of the Code contains the alternative minimum tax adjustments applicable to individuals. Section 56(b)(3) sets forth the treatment of incentive stock options under the alternative minimum tax. This section provides that section 421 shall not apply to the transfer of stock acquired pursuant to the exercise of an incentive stock option, as defined in section 422.

Section 56(b)(3) of the Code further provides that section 422(c)(2) shall apply in any case where the disposition of stock obtained pursuant to the exercise of an ISO, and the alternative minimum tax inclusion of ISO income, are within the same taxable year, and such section shall not apply in any other case.

Finally, section 56(b)(3) of the Code also provides that the adjusted basis of any stock acquired pursuant to an ISO shall be determined on the basis of the treatment specified in section 56(b)(3).

Section 53(a) of the Code provides that there shall be allowed as a credit against the tax imposed by Chapter 1 of the Code for any taxable year an amount equal to the minimum tax credit for such taxable year.

The amount of the minimum tax credit for any taxable year is the excess (if any) of the adjusted net minimum tax imposed for all prior taxable years beginning after 1986 over the amount allowable as a credit for such prior taxable years. The net minimum tax is defined in section 53(d)(1)(A) as the tax imposed by section 55.

The amount of the minimum tax credit allowable for any taxable year is limited to the excess (if any) of the regular tax liability of the taxpayer for the taxable year, reduced by certain credits, over the tentative minimum tax for the taxable year.

Section 1.55-1 of the regulations provides a general rule for the computation of alternative minimum taxable income. The rule in section 1.55-1(a) of the regulations states that, except as otherwise provided by statute, regulations, or other published guidance issued by the Commissioner, all Internal Revenue Code provisions that apply in determining the regular taxable income of a taxpayer also apply in determining the alternative minimum taxable income of the taxpayer.

Section 2501(a) of the Code imposes a gift tax for each calendar year on the transfer of property by gift during the calendar year.

Section 2511 of the Code provides that the gift tax shall apply whether the transfer is in trust or otherwise, whether the gift is direct or indirect, and whether the property is real or personal, tangible or intangible.

Section 2512(b) of the Code provides that where property is transferred for less than an adequate and full consideration in money or money’s worth, the amount by which the value of the property exceeded the value of the consideration shall be deemed a gift.

Section 2516 of the Code provides that where a husband and wife enter into a written agreement relative to their marital and property rights and divorce occurs within the 3-year period beginning on the date 1 year before such agreement is entered into (whether or not such agreement is approved by the divorce decree), any transfers of property or interests in property made pursuant to such agreement (1) to either spouse in settlement of his or her marital or property rights, (2) to provide a reasonable allowance for the support of issue of the marriage during minority, shall be deemed to be transfers made for a full and adequate consideration in money or money’s worth.

In the present case, section 2516 is not applicable to the determination of the taxability of the transfer of options between X and E since the parties did not enter into any agreement relative to their marital and property rights in the options within the time prescribed in section 2516.

Under Rev. Rul. 79-110, 1979-1 C. B. 315, in the absence of the applicability of section 2516, the principles presented in section 25.2512-8, Rev. Rul. 68-279, 1968-2 C.B. 414, and Harris v. Commissioner, 340 U.S. 106 (1950), must be considered in determining the gift tax consequences of the transaction.

Section 25.2512-8 of the Gift Tax Regulations provides that transfers reached by the gift tax are not confined to those only which, being without a valuable consideration, accord with the common law concept of gifts, but embrace as well sales, exchanges, and other dispositions of property for a consideration to the extent that the value of the property transferred by the donor exceeds the value in money or money's worth of the consideration given therefore. However, a sale, exchange, or other transfer of property made in the ordinary course of business (a transaction which is bona fide, at arm's length, and free from any donative intent), will be considered as made for an adequate consideration in money or money's worth. A consideration not reducible to a value in money or money's worth, as love and affection, promise of marriage, etc., is to be wholly disregarded, and the entire value of the property transferred constitutes the amount of the gift. Similarly, a relinquishment or promised relinquishment of dower or curtesy, or a statutory estate created in lieu of dower or curtesy, or other marital right in the spouse's property or estate, shall not be considered to any extent a consideration "in money or money's worth."

In Rev. Rul. 68-379, a husband and wife entered into an agreement incident to a legal separation. Pursuant to the agreement, the husband transferred property to his wife in full settlement of her property and support rights. The question arose as to the application of the gift tax to such transfer.

The ruling provides that, generally, a husband has a duty to support his wife during their joint lives or until she remarries. The satisfaction of this legal obligation does not have the effect of diminishing the husband's estate any more than the satisfaction of any other legal obligation. Although section 25.2512-8 specifically states that the release of dower or curtesy or a statutory substitute for dower or curtesy (inheritance rights) is not a consideration in money or money's worth which would prevent taxation of the transfer, the regulations make no reference to support rights. Consequently, since support rights are distinguishable from inheritance rights, a surrender of support rights is not a surrender of "other marital rights," as that phrase is used in the regulations. A release of support rights by a wife or husband constitutes a consideration in money or money's worth.

However, the Supreme Court in Harris v. Commissioner, 340 U.S. 106 (1950), provides an exception to these general rules. Stating that, "[i]t is 'the transfer' of the property with which the gift tax statute is concerned …," the Court found that, "[i]f 'the transfer' of marital rights in property is effected by the parties, it is pursuant to a 'promise or agreement' in the meaning of the statute. If 'the transfer' is effected by a court decree, no 'promise or agreement' of the parties is the operative fact." Id. at 111.

The Court noted that such a transfer between a husband and wife is not "in the ordinary course of business in any conventional sense…, [but] if two partners on dissolution of the firm entered into a transaction of this character or if chancery did it for them, there would seem to be no doubt that the unscrambling of business interests would satisfy the spirit of the Regulations. No reason is apparent why husband and wife should be under a heavier handicap absent a statute which brings all marital property settlements under the gift tax." Id. at 112.

Accordingly, the Court concluded that if a transfer in exchange for a spouse's marital rights is effectuated pursuant to a divorce decree, the exchange is not subject to the gift tax.

In the present case, X and E have agreed to enter into a settlement of their dispute relative to the division of the options. The resolution of this dispute occurred in the context of a judicial process and was formalized on the judgment date. Therefore, the transfer is effected by a court decree as in Harris.

Based solely on the information submitted, we rule as follows:

1. The Court's recognizing X's community property interest in the ISOs and requiring E to exercise X's ISOs only in accordance with X's instructions and requiring E to designate X as the beneficiary of X's share of the options will not violate the requirements of section 422(b)(5) of the Code, relating to nontransferability and lifetime exercise by the employee.

2. Alternative minimum taxable income recognized on E's exercise of X's ISOs will be includible in X's alternative minimum taxable income for federal tax purposes.

3. Income recognized on E's exercise of X's NSOs that remain in E's name or under E's control will be included in X's income for federal income tax purposes.

4. X will be entitled to any alternative minimum tax credits as a result of E's exercise of X's ISOs.

5. Under principles regarding taxation of equal division of community property, none of the following will be a taxable event: (i) the recognition of X's ownership of X's options; (ii) the transfer to X of X's NSOs; (iii) the transfer of stock from E or Company to X after the exercise by E of any of X's options; or (iv) E's designation of X as beneficiary of X's options.

6. Under section 424(c) of the Code, a transfer between E and X (or directly from Company to X) of stock resulting from the exercise of X's ISOs will not be a disposition of such stock, and all subsequent tax consequences with respect to such stock will be X's.

7. Income recognized on X's exercise of X's NSOs that have been fully transferred to X will be included in X's income for federal income tax purposes.

8. Gain or loss on the sale of stock received by E on exercise of any of X's options that remain in E's name is includible in calculating X's gross income, regardless of whether such stock is first registered in X's name.

9. Gain or loss on the sale of any stock received by X on the exercise of any of X's NSOs is includible in calculating X's gross income.

10. Reimbursements made by one former spouse to the other in the event that Company withholds any taxes from a former spouse that are properly the liability of the other former spouse will be tax-free transfers incident to divorce.

11. X is entitled to the credit for income tax withheld from the stock or cash proceeds (or paid to Company by X for properly due income tax withholding) at the time of the exercise of the nonstatutory stock options of which X is beneficial owner.

12. The division of the options between X and E pursuant to the Stipulation and the JRI will be made for full and adequate consideration in money or money's worth and will not be a taxable gift by X under section 2501.

13. If E dies while X's ISOs are in E's name, X, as beneficial owner and designated beneficiary, may subsequently exercise such options and receive and dispose of the resulting stock with the same tax consequences as if E had exercised the ISOs.

Except as expressly provided herein, no opinion is expressed or implied concerning the tax consequences of any aspect of any transaction or item discussed or referenced in this letter.

This ruling is directed only to the taxpayer requesting it. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.

A copy of this letter must be attached to any income tax return to which it is relevant.

The rulings contained in this letter are based upon information and representations submitted by the taxpayer and accompanied by a penalty of perjury statement executed by an appropriate party. While this office has not verified any of the material submitted in support of the request for rulings, it is subject to verification on examination.

Sincerely,

Robert Misner
Senior Technician Reviewer, Executive
Compensation (Employee Benefits)
(Tax Exempt & Government Entities)