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Employee Stock Option Division in Divorce: Valuation, Tax and Risk Considerations

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Employee stock option division in divorce is a confusing and complex area fraught with tax complications and imprecise valuation methods.

Before we discuss the division of Employee Stock Options, a basic understanding of how they function is important.

Employee Stock Option Definition:

An Employee Stock Option is the right given by an employer to an employee to purchase a specified number of shares of the employer's stock for a specified price for a specified time.

Important terms:

Optionee – the employee to whom options are granted.

Exercise – to purchase stock using an option.

Grant Date – the date the option becomes the employee's property.

Grant or Exercise Price – the price at which the employee may purchase the stock.

Exercise or Vesting Date – the first date the employee may use the option to buy stock. It is common for a single grant to have a vesting schedule which sets out the percentage or number of the options that become vested at each vesting date.

Unvested Options – options that have not yet reached their vesting date.

Expiration Date – the last date an option can be exercised; if it is not exercised by then, it is lost and any value is forfeited.

In the Money Options – options whose fair market value exceeds the grant price.

Underwater Options – options whose grant price exceeds the fair market value.

Types of Employee Stock Options:

There are two types of **Employee Stock Options**

– **Nonqualified Stock Options** and **Incentive Stock Options**, also referred to as **Qualified Stock Options**. There is a difference between how these two types of options are treated for income tax purposes.

Nonqualified Stock Options. Exercise of Nonqualified Stock Options generates compensation income for the “spread,” the difference between the fair market price and the grant price. This compensation is ordinary income and is reported on the employee's Form W-2.

If these shares are later sold at a gain above what the market price was on the date of option exercise, capital gains will be generated. Whether the gains are considered short or long term depends on whether or not the stock shares were held for more than one year since the date of exercise. To determine the gain or loss on the sale of the stock, the shareholder's basis is equal to the value of the shares at the time of exercise of the options.

Incentive Stock Options. Incentive stock options have qualified with the IRS to receive favorable tax treatment. As long as the stock shares acquired through the option exercise are held for the later of two years from the date of grant or one year from the date of exercise, no income is recognized at the time of exercise. Capital gains are recognized once the stock is sold. However, the “spread” from the exercise of Incentive Stock Options becomes a tax preference item for Alternative Minimum Tax calculations and may cause the optionee to fall into an Alternative Minimum Tax situation that year. A consultation with a qualified tax professional is always advised prior to exercising Incentive

Stock Options.

A disposition of the shares before either of the one and two-year holding periods is met creates a “disqualifying disposition,” which causes the exercise to generate ordinary income. But, the sale within a year of exercise still can produce Alternative Minimum Tax if the exercise and sale do not occur within the same calendar year.

Determining the Community Property Portion of the Stock Options:

Under California law, stock options that were granted and vested during the marriage are considered community property. Stock options that were granted during the marriage but vest after date of separation are in part community property. A time formula or coverture fraction is usually applied to determine the community share. Two cases gave rise to different formulas which are detailed below.

In re Marriage of Hug (1984) 154 Cal.App.3d 780, the community property portion was determined by the formula where:

- DOH – Date of Hire
- DOS – Date of Separation
- DOE – Date of Exercisability

$$\frac{\text{DOH DOS}}{\text{DOH DOE}} \times \text{Number of shares exercisable} = \text{Community Property Shares}$$

Here’s an example using the *Hug* formula

- Date of Marriage = 5/1/1978
- # Shares = 1000
- DOH = 3/1/1980
- DOS = 6/1/2006
- DOE = 9/1/2008

Using the above information, the number of months between DOH and DOS = 315.

The number of months between DOH and DOE = 342.

Therefore, $315/342 = 92\% \times 1000 \text{ shares} = 920$ community property shares.

The *Hug* formula is mainly used in cases where the options were intended to attract a new employee and to reward past services.

In re Marriage of Nelson (1986) 177 Cal.App.3d 170, the community property was determined by the formula where:

- DOG – Date of Grant
- DOS – Date of Separation
- DOE – Date of Exercisability

$$\frac{\text{DOG DOS}}{\text{DOG DOE}} \times \text{Number of shares exercisable} = \text{Community Property Shares}$$

Using the *Nelson* formula:

- Date of Marriage = 5/1/1978
- # Shares = 1000
- DOG = 9/1/2002
- DOS = 6/1/2006
- DOE = 9/1/2008

In this case, the number of months between DOG and DOS = 45.

The number months between DOG and DOE = 72.

Therefore, $45/72 = 63\% \times 1000 \text{ shares} = 630$ community property shares.

The *Nelson* formula is mainly used in cases where the options were granted as compensation for future service and as an incentive to stay with the company.

Whichever time formula is used, the longer the time between the date of separation and the date the option can be exercised (vests), the smaller the portion of each grant that would be considered community property.

Division and Distribution of Employee Stock Options between Spouses:

There are two methods of distributing Employee Stock Options between an employee spouse and a non-employee spouse. They are the Deferred Distribution and Present Valuation methods.

Deferred Distribution:

Transfer to non-employee spouse. Only Nonqualified Stock Options can be transferred. The transfer of an Incentive Stock Option constitutes a “disqualifying disposition,” which causes the option to lose its special tax status and transforms it into a Nonqualified Stock Option. Although the IRS allows transfers of Nonqualified Stock Options as a nontaxable transfer between spouses, not all employer

Employee Stock Option plans allow for such transfers. If such a transfer is allowed, the employer sets up an account for the non-employee spouse and will exercise the options at his or her direction. The non-employee spouse will receive a Form 1099 and must include the exercise income in ordinary income for the year of exercise. As FICA and Medicare taxes will be withheld from the employee spouse, the Marital Settlement Order and Domestic Relations Order should include a provision for the employer to withhold funds from the non-employee spouse's option proceeds to repay these taxes to the employee spouse. Most companies that do allow such transfers require a Domestic Relations Order that conforms to a format designed by them. Obtaining their template prior to drafting the Domestic Relations Order is advised.

Deferred Distribution Upon Exercise of Options. Where Employee Stock Options are not transferable, the employee is often instructed to hold in beneficial interest or to set up an option trust to hold the non-employee spouse's share of the options. The optionee must exercise at the non-employee spouse's direction. Taxation effects are as above.

Deferred distribution methods have the effect of sharing the risk inherent in options between the spouses. However, they force the spouses to continue to be linked economically, and the non-employee spouse is dependent upon the employee's continuing to be employed by the same employer. It is common for stock option plans to allow employees 90 days in which to exercise options following separation from the employer. Failure to exercise in the time allotted results in forfeiture of the option proceeds.

Care must also be taken if the employee is considered an insider or control person and is subject to restrictions regarding timing of stock trading or option exercise. In that case, a Rule 10b5-1 Trading Plan may be constructed and filed with the SEC. Such a plan enables insiders to trade shares or exercise options of their company stock during periods when they are usually prohibited from trading.

Present Valuation:

In this method, the stock options are valued using one of the valuation methods below, and the non-employee

spouse is allocated compensating assets in lieu of the stock options. A weakness in this approach is that the employee spouse might leave the company and become unable to exercise the options, or their value may decline. On the other hand, if the value of the options increases, the employee spouse enjoys 100% of the increase.

Valuation methods:

Each of the methods below has both strengths and weaknesses.

Intrinsic Value Method (In the Money Method). This method values the option as its "spread," which is the difference between the fair market value and the grant price. It does not consider the volatility of the stock or the time value, which incorporates the right of the optionee to exercise the options at a time in the future at a predetermined grant price. It therefore ignores the potential future value of the options and those that are "underwater." However, it is the simplest method to use.

Black Scholes Method. This method computes the value of the options using a formula. The formula determines the present value by taking into account the stock's current price, dividend rate, assumptions regarding a risk free interest rate, time value, and the stock's price volatility. A weakness in the Black Scholes method is its assumption that the employee does not exercise the option until the last day, when in reality employees can exercise options at any time after they are vested. However, Black Scholes is still by far the most widely used method for valuing Employee Stock Options.

Binomial Method. The Binomial (or Lattice Method) is a complex formula that creates a tree of possible option values based on the same variable as the Black Scholes method. Additionally, it takes into account the potential early exercise of options rather than assuming the optionee holds them until the latest exercise date. This method tends to produce a slightly lower value and is not as widely utilized as the Black Scholes Method.

None of the above methods takes into account the potential tax effects of exercising the options. Both

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income and payroll tax consequences reduce the after-tax present value of the options, and clients should be made aware of potential tax consequences.

Stock Option Income Includable for Child Support Calculations:

Income from the exercise of stock options is considered compensation for purposes of child support calculations. There is nothing definitive as to whether the income from stock options that have been present valued and traded for another asset is includable in child support calculations. However, there seems to be no doubt that options granted after the date of separation would be included in child support calculations. See, e.g., *Marriage of Kerr* (1999) 77 Cal App. 4th 97, 95.

Documentation Needed to Analyze Employee Stock Options:

Copies of the following documents should be obtained in cases concerning Employee Stock Options:

- The stock option plan;
- Internal correspondence issued by the company at the time of the grants;
- A schedule of the grants showing:
 1. Date of each option granted
 2. Number of options granted at each date
 3. Exercise price for each option
 4. Expiration date of each set of options
 5. Date of vesting for each set of options;
- A transaction history of options that have been exercised showing the date and number of options exercised.

I hope this article has provided some insight and suggestions for dealing with the complex and unique aspects of Employee Stock Options in divorce. Due to the complexity of this area, this article should not be relied upon without consulting a qualified attorney who can review the specific documentation for each case. ■

Be in the Drivers Seat With Affirmative Legislation

Have you approached an issue in a case and found the application of law wasn't adequate or was inequitable? If so, we want to hear from you.

In addition to tracking family law bills and taking a position of support, opposition or seeking amendments, FLEXCOM is expanding its proactive role with Legislation.

FLEXCOM has written legislation to be introduced during the next legislative session. More information will be provided on FLEXCOM's legislation and also a listing of several of other Bar Section's affirmative legislative proposals in the last Family Law News issue of the year.

If there is a statute in a particular area of family law, which you believe should be changed or refined, contact the nearest standing committee chairperson listed in this issue with your suggestions or send an e-mail to: elh-family-law@comcast.net.

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2005/2006 Legislative Chair