

## Section 61.—Gross Income Defined

26 CFR 1.61-1: *Gross income.*  
(Also: § 83, 1041; 1.83-7, 1.1041-1T.)

**Gross income; transfers of property incident to divorce.** A taxpayer who transfers interests in nonstatutory stock options and nonqualified deferred compensation to the taxpayer's former spouse incident to divorce is not required to include an amount in gross income upon the transfer. Rather, the former spouse is required to include an amount in gross

income when the former spouse exercises the stock options or when the deferred compensation is paid or made available to the former spouse.

### Rev. Rul. 2002-22

#### ISSUES

(1) Is a taxpayer who transfers interests in nonstatutory stock options and nonqualified deferred compensation to the taxpayer's former spouse incident to divorce required to include an amount in gross income upon the transfer?

(2) Is the taxpayer or the former spouse required to include an amount in gross income when the former spouse exercises the stock options or when the deferred compensation is paid or made available to the former spouse?

#### FACTS

Prior to their divorce in 2002, *A* and *B* were married individuals residing in State *X* who used the cash receipts and disbursements method of accounting.

*A* is employed by Corporation *Y*. Prior to the divorce, *Y* issued nonstatutory stock options to *A* as part of *A*'s compensation. The nonstatutory stock options did not have a readily ascertainable fair market value within the meaning of § 1.83-7(b) of the Income Tax Regulations at the time granted to *A*, and thus no

amount was included in *A*'s gross income with respect to those options at the time of grant.

*Y* maintains two unfunded, nonqualified deferred compensation plans under which *A* earns the right to receive post-employment payments from *Y*. Under one of the deferred compensation plans, participants are entitled to payments based on the balance of individual accounts of the kind described in § 31.3121(v)(2)-1(c)(1)(ii) of the Employment Tax Regulations. By the time of *A*'s divorce from *B*, *A* had an account balance of \$100*x* under that plan. Under the second deferred compensation plan maintained by *Y*, participants are entitled to receive single sum or periodic payments following separation from service based on a formula reflecting their years of service and compensation history with *Y*. By the time of *A*'s divorce from *B*, *A* had accrued the right to receive a single sum payment of \$50*x* under that plan following *A*'s termination of employment with *Y*. *A*'s contractual rights to the deferred compensation benefits under these plans were not contingent on *A*'s performance of future services for *Y*.

Under the law of State *X*, stock options and unfunded deferred compensation rights earned by a spouse during the period of marriage are marital property subject to equitable division between the spouses in the event of divorce. Pursuant to the property settlement incorporated

into their judgment of divorce, A transferred to B (1) one-third of the nonstatutory stock options issued to A by Y, (2) the right to receive deferred compensation payments from Y under the account balance plan based on \$75x of A's account balance under that plan at the time of the divorce, and (3) the right to receive a single sum payment of \$25x from Y under the other deferred compensation plan upon A's termination of employment with Y.

In 2006, B exercises all of the stock options and receives Y stock with a fair market value in excess of the exercise price of the options. In 2011, A terminates employment with Y, and B receives a single sum payment of \$150x from the account balance plan and a single sum payment of \$25x from the other deferred compensation plan.

## LAW AND ANALYSIS

### *Section 1041 and the assignment of income doctrine*

Section 1041(a) provides that no gain or loss is recognized on a transfer of property from an individual to or for the benefit of a spouse or, if the transfer is incident to divorce, a former spouse. Section 1041(b) provides that the property transferred is generally treated as acquired by the transferee by gift and that the transferee's basis in the property is the adjusted basis of the transferor.

Section 1041 was enacted in part to reverse the effect of the Supreme Court's decision in *United States v. Davis*, 370 U.S. 65 (1962), which held that the transfer of appreciated property to a spouse (or former spouse) in exchange for the release of marital claims was a taxable event resulting in the recognition of gain or loss to the transferor. See H.R. Rep. No. 432, 98<sup>th</sup> Cong., 2d Sess. 1491 (1984). Section 1041 was intended to "make the tax laws as unintrusive as possible with respect to relations between spouses" and to provide "uniform Federal income tax consequences" for transfers of property between spouses incident to divorce, "notwithstanding that the property may be subject to differing state property laws." *Id.* at 1492. Congress thus intended that § 1041 would eliminate differing federal tax treatment of property transfers and divisions between divorcing

taxpayers who reside in community property states and those who reside in non-community property states.

The term "property" is not defined in § 1041. However, there is no indication that Congress intended "property" to have a restricted meaning under § 1041. To the contrary, Congress indicated that § 1041 should apply broadly to transfers of many types of property, including those that involve a right to receive ordinary income that has accrued in an economic sense (such as interests in trusts and annuities). *Id.* at 1491. Accordingly, stock options and unfunded deferred compensation rights may constitute property within the meaning of § 1041. See also *Balding v. Commissioner*, 98 T.C. 368 (1992) (marital rights to military pension treated as property under § 1041).

Although § 1041 provides nonrecognition treatment to transfers between spouses and former spouses, whether income derived from the transferred property and paid to the transferee is taxed to the transferor or the transferee depends upon the applicability of the assignment of income doctrine. As first enunciated in *Lucas v. Earl*, 281 U.S. 111 (1930), the assignment of income doctrine provides that income is ordinarily taxed to the person who earns it, and that the incidence of income taxation may not be shifted by anticipatory assignments. However, the courts and the Service have long recognized that the assignment of income doctrine does not apply to every transfer of future income rights. See, e.g., *Rubin v. Commissioner*, 429 F.2d 650 (2d Cir. 1970); *Hempt Bros., Inc. v. United States*, 490 F.2d 1172 (3d Cir. 1974), cert. denied, 419 U.S. 826 (1974); Rev. Rul. 80-198 (1980-2 C.B. 113). Moreover, in cases arising before the effective date of § 1041, a number of courts had concluded that transfers of income rights between divorcing spouses were not voluntary assignments within the scope of the assignment of income doctrine. See *Meisner v. United States*, 133 F.3d 654 (8<sup>th</sup> Cir. 1998); *Kenfield v. United States*, 783 F.2d 966 (10<sup>th</sup> Cir. 1986); *Schulze v. Commissioner*, T.C.M. 1983-263; *Cofield v. Koehler*, 207 F. Supp. 73 (D. Kan. 1962).

In *Hempt Bros., Inc. v. United States*, the court concluded that the assignment of income doctrine should not apply to the transfer of accounts receivable by a

cash basis partnership to a controlled corporation in a transaction described in § 351(a), where there was a valid business purpose for the transfer of the accounts receivable together with the other assets and liabilities of the partnership to effect the incorporation of an ongoing business. The court reasoned that application of the assignment of income doctrine to tax the transferor in such circumstances would frustrate the Congressional intent reflected in the nonrecognition rule of § 351(a). Accordingly, the transferee, not the transferor, was taxed as it received payment of the receivables. In Rev. Rul. 80-198, the Service adopted the court's position in *Hempt Bros.*, but ruled that the assignment of income doctrine would nonetheless apply to transfers to controlled corporations where there was a tax avoidance purpose.

Similarly, applying the assignment of income doctrine in divorce cases to tax the transferor spouse when the transferee spouse ultimately receives income from the property transferred in the divorce would frustrate the purpose of § 1041 with respect to divorcing spouses. That tax treatment would impose substantial burdens on marital property settlements involving such property and thwart the purpose of allowing divorcing spouses to sever their ownership interests in property with as little tax intrusion as possible. Further, there is no indication that Congress intended § 1041 to alter the principle established in the pre-1041 cases such as *Meisner* that the application of the assignment of income doctrine generally is inappropriate in the context of divorce.

### *Specific provisions governing nonstatutory stock options*

Section 83(a) 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. In the case of nonstatutory stock options that do not have a readily

ascertainable fair market value at the date of grant, § 83 does not apply to the grant of the option, but applies to property received upon exercise of the option or to any money or other property received in an arm's length disposition of the option. See § 83(e) and § 1.83-7(a).

Although a transfer of nonstatutory stock options in connection with a marital property settlement may, as a factual matter, involve an arm's length exchange for money, property, or other valuable consideration, it would contravene the gift treatment prescribed by § 1041 to include the value of the consideration in the transferor's income under § 83. Accordingly, the transfer of nonstatutory stock options between divorcing spouses is entitled to nonrecognition treatment under § 1041.

When the transferee exercises the stock options, the transferee rather than the transferor realizes gross income to the extent determined by § 83(a). Since § 1041 was intended to eliminate differing federal tax treatment for property transferred or divided between spouses in connection with divorce in community property states and in non-community property states, § 83(a) is properly applied in the same manner in both contexts. Where compensation rights are earned through the performance of services by one spouse in a community property state, the portion of the compensation treated as owned by the non-earning spouse under state law is treated as the gross income of the non-earning spouse for federal income tax purposes. *Poe v. Seaborn*, 282 U.S. 101 (1930). Thus, even though the non-employee spouse in a non-community property state may not have state law ownership rights in nonstatutory stock options at the time of grant, § 1041 requires that the ownership rights acquired by such a spouse in a marital property settlement be given the same federal income tax effect as the ownership rights of a non-employee spouse in a community property state. Accordingly, upon the subsequent exercise of the nonstatutory stock options, the property transferred to the non-employee spouse has the same character and is includible in the gross income of the non-employee spouse under § 83(a) to the same extent as if the non-employee

spouse were the person who actually performed the services.

The same conclusion would apply in a case in which an employee transfers a statutory stock option (such as those governed by § 422 or 423(b)) contrary to its terms to a spouse or former spouse in connection with divorce. The option would be disqualified as a statutory stock option, see §§ 422(b)(5) and 423(b)(9), and treated in the same manner as other nonstatutory stock options. Section 424(c)(4), which provides that a § 1041(a) transfer of stock acquired on the exercise of a statutory stock option is not a disqualifying disposition, does not apply to a transfer of the stock option. See H.R. Rep. No. 795, 100<sup>th</sup> Cong., 2d Sess. 378 (1988) (noting that the purpose of the amendment made to § 424(c) is to "clarif[y] that the transfer of stock acquired pursuant to the exercise of an incentive stock option between spouses or incident to divorce is tax free").

## CONCLUSION

Under the present facts, the interests in nonstatutory stock options and nonqualified deferred compensation that *A* transfers to *B* are property within the meaning of § 1041. Section 1041 confers nonrecognition treatment on any gain that *A* might otherwise realize when *A* transfers these interests to *B* in 2002. Further, the assignment of income doctrine does not apply to these transfers. Therefore, *A* is not required to include in gross income any income resulting from *B*'s exercise of the stock options in 2006 or the payment of deferred compensation to *B* in 2011. When *B* exercises the stock options in 2006, *B* must include in income an amount determined under § 83(a) as if *B* were the person who performed the services. In addition, *B* must include the amount realized from payments of deferred compensation in income in the year such payments are paid or made available to *B*. 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.

This ruling does not apply to transfers of property between spouses other than in

connection with divorce. This ruling also does not apply to transfers of nonstatutory stock options, unfunded deferred compensation rights, or other future income rights to the extent such options or rights are unvested at the time of transfer or to the extent that the transferor's rights to such income are subject to substantial contingencies at the time of the transfer. See *Kochansky v. Commissioner*, 92 F.3d 957 (9<sup>th</sup> Cir. 1996). Transfers of certain types of property incident to divorce, the tax consequences of which are governed by a specific provision of the Code or regulations (for example, § 402, 408, 414, 424, or 453B) are not affected by this ruling.

## HOLDINGS

(1) A taxpayer who transfers interests in nonstatutory stock options and nonqualified deferred compensation to the taxpayer's former spouse incident to divorce is not required to include an amount in gross income upon the transfer.

(2) The former spouse, and not the taxpayer, is required to include an amount in gross income when the former spouse exercises the stock options or when the deferred compensation is paid or made available to the former spouse.

## PROSPECTIVE APPLICATION

The Service will apply § 7805(b) and assignment of income principles to treat income as gross income of the transferor and not of the transferee if—

(i) The income is attributable to an interest in nonstatutory stock options, unfunded deferred compensation rights, or other similar intangible property rights;

(ii) The options or rights were transferred from one party to a divorce to the other party to the divorce;

(iii) The transfer was required by a provision of an agreement or court order;

(iv) The provision was contained in the agreement or order before November 9, 2002; and

(v) (a) The agreement or court order specifically provides that the transferor must report gross income attributable to the transferred interest, or

(b) It can be established to the satisfaction of the Service that the transferor

has reported the gross income for federal income tax purposes.

## EFFECT ON OTHER DOCUMENTS

Rev. Rul. 87-112 (1987-2 C.B. 207) which deals with the treatment of transfers of United States savings bonds between spouses or former spouses, is clarified by eliminating references to assignment of income principles. As so clarified, the ruling is reaffirmed respecting the application of § 454 and the regulations thereunder to the transfer and the determination of the transferee's basis.

## FURTHER INFORMATION

For further information or questions regarding § 61 or 1041, contact Edward Schwartz of the Office of Associate Chief Counsel (Income Tax and Accounting) at (202) 622-4960. For further information or questions regarding § 83, 402, 408, 414, 422, 423, 424, or 453B, contact Erinn Madden of the Office of the Associate Chief Counsel (Tax Exempt and Government Entities) at (202) 622-6030. These are not toll-free calls.