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## [QdroDesk.com](http://QdroDesk.com) - September/October 2014 QDRO Newsletter - Volume 3, Issue 2

The goal of our monthly QDRO Newsletter is to keep you informed of Hot Topics regarding all aspects of QDROs. If you find our newsletter valuable, please forward it to a colleague. We hope you enjoy this month's topic.

### **STOCK OPTIONS AND THE DISTRIBUTION OF PROPERTY IN DIVORCE**

**Definition:** A stock option is the right (option) given to an employee by a corporation to purchase a specific number of shares of the corporation's stock during a specified period of time at a fixed purchase price.

**General Discussion:** A stock option gives the owner the right to purchase stock at the strike price, which is below market price of the stock. If an employee is given a stock option he/she is not required to purchase the stock but can or may elect to exercise the option.

When exercised, the stock is sold (usually at the same time), and the difference between the strike price and the market price is the employee's profit. (The routine is not necessarily a shortcut to Easy Street: when the market price of a company dips below the strike price, the options are worthless.) Nevertheless, during runups in the stock market, options can become quite valuable. Options carry a grant date, when the employer conveys the option to the employee; a vesting date, usually one to five years, after which the employee owns the option outright; and an exercise or maturity date, when it may be used.

Stock options have become increasingly important in the distribution of property in divorce.

Stock options are either statutory or nonstatutory. Statutory options, which are often awarded to key management as incentives, give the employee the opportunity to take advantage of special federal tax treatment accorded incentive options. The employee does not pay ordinary income tax on the options when they are granted or exercised; instead, after they are exercised and sold they are taxed at the lower capital gains rate, provided they are held for the required amount of time. Thus, the employee benefits because capital gains taxes are lower than income taxes. On the other hand, nonstatutory options usually are taxed as regular income when the option is exercised (when the stock is purchased).

Corporations grant options for a number of reasons, so each stock option grant should be analyzed on a case-by-case basis. The more common reasons are as follows:

1. The corporation wants to provide an incentive for the employee to remain with the company. This would represent compensation for services to be rendered in the future.

2. Options are offered to attract new employees who are usually paid below the going rate in return for part of the future growth of the corporation. This would represent deferred compensation for services rendered in the present.
3. The corporation wants to give the employee a bonus for having done a good job. This would represent compensation for services rendered in the past.

The disposition of options as compensation for future services, deferred compensation, or a bonus for work already performed -- all can be and are argued when couples divorce.

**Classification:** Unexercised stock options sometimes make for difficulties during settlement negotiations because the court must decide if the options reward efforts made by the owning party during the marriage (and are marital property) or a reward for future efforts (and hence separate property). In a divorce, couples battle about both the classification and distribution of unexercised options because the employee spouse contends that the options are his or her separate property, in part or in whole, because the value is not received during the marriage, and the non-employee spouse contends that they were earned during the marriage for past services. Thus, the courts must decide today about a reward that may be for past or future. Courts almost universally hold that vested or unvested stock options earned during a marriage are marital.

In order to determine if stock options are a marital asset subject to distribution, the critical issue revolves around the purpose (reason) the corporation granted the stock options. Were they granted for past, present or future service? The courts generally follow a four-step process to determine the marital portion:

Step 1: The court must determine the number of shares granted for past and future service.

Step 2: The number of shares granted for past service is deemed to be marital to the extent that the marriage coincides with the period of employment until the granting of the options.

Most states apply a coverture fraction (time rule) to determine the marital portion. The numerator of the fraction represents the later of the beginning of employment or the beginning of the marriage to the date the options were granted, and the denominator represents the date of employment to the date the options were granted.

Step 3: A second coverture fraction (time rule) applies to the number of shares granted for future service to determine the marital portion. This would represent the growth from the date the options were granted to the date the marriage ended (cut off date) and any additional growth due to contributions of the non-employee spouse.

Step 4: All options found to be marital could be divided between the parties. Any options not found to be marital would remain the sole property of the employee spouse.

Most equitable distribution states have adopted the following positions relative to the classification of options:

Options that are exercisable on the date the marriage ended (and may not be cancelled), and are said to be vested are marital property.

Options that are not exercisable as of the date the marriage ended and may be lost as a result of events occurring later (and are not vested) are the separate property of the employee spouse even though they may vest in the future.

Most community property states take the opposite position. They have determined that unvested stock options constitute a contingent interest in property and therefore are a community asset.

The purpose of stock options granted to an employee that are designed so that they vest and become exercisable over a period of time represent both compensation for the employee's past services and incentive for the employee to continue with employment in the future. The options that have already vested reward past service rendered during the marriage, and, therefore are marital property. Those options that have not vested represent a future right contingent upon continued service and therefore would be considered non-marital property.

**Valuation:** The valuation of stock options is complex and depends on the volatility of the stock, the time remaining to exercise the option, the risk-free interest rate, the strike price and the stock price. The option is valued at the market value of the stock on the date of valuation less all costs associated with exercising the option. However, this calculation can be complicated by other factors such as:

1. Tax liability to the optionee,
2. The optionee may have to continue employment in order to exercise the option,
3. After exercising the option the optionee may be prevented from selling the shares,
4. The options may not be vested on the date the marriage ended,
5. The optionee may have to borrow money to exercise the option, and
6. There could be other contingencies.

**Distribution:**

**Immediate Distribution (Immediate Offset):** Some courts take the position that this is the most equitable approach to use if the options can be valued. This is true even for options that have not been exercised. The optionee bears all risk relative to loss due to any cause. The optionee is awarded all the options and the non-employee spouse receives property of equal value.

**Deferred Distribution:** Because the possibility exists that the options might not be exercised, most courts retain jurisdiction until they expire or are exercised to make a distribution between the parties. Professionals should note that a domestic relations order cannot be used to divide stock options.

--Conclusion--

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If you have any questions regarding our Newsletter or [QdroDesk.com](http://www.QdroDesk.com), please let me know and thank you for giving us the opportunity to share our Newsletter with you. We appreciate your business, and the confidence you have placed in us.

For more QDRO information and online QDRO preparation services, please visit us online at: <http://www.QdroDesk.com>

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