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Stock Options and Divorce

A) Overview:

Many executives of both public and private companies are granted stock options and restricted stock units either as an inducement to join a company, reward for past contributions, or as an incentive to remain tied to the company. These can represent an extremely lucrative portion of a marital estate; yet their valuations are often miscalculated.

B) Issues to Address:

The primary issues to address with respect to stock options in divorce is whether they are marital, vested, how will they be valued, how will they be divided, and what are the tax considerations. Whether they are treated as an asset or income or both will impact property division and spousal and child support. Options which are awarded and vested during the marriage are 100% marital. For options which are awarded but not vested, a determination must be made as to whether the options were granted as a result of past service or future performance.

C) Types of Stock Options and Tax Consequences:

Stock Options come in two varieties- incentive stock options and non-qualified stock options. Incentive stock options are not taxed upon exercise, but rather upon the sale of the underlying stock. Shares held for one year from the date of exercise and two years from the date of the grant receive long-term capital gain tax treatment. Incentive Stock Options must be exercised within 10 years of the grant and they can only be transferred as a result of the employee's death. Non-qualified stock options are far more common. They are taxed at the date of exercise at ordinary income tax rates that reflect the difference in price between the lesser exercise (strike) price and the fair market value.

D) Division and Valuation:

The employee's benefits have to be reviewed to determine whether the plan permits the employee spouse to transfer the options in kind to the non-employee spouse. It is much more likely that an in kind transfer is not feasible, and therefore a constructive trust might need to be executed whereby the employee spouse will in fact effectuate the transfer to the trust for the benefit of the non-employee spouse. In this case, the employee spouse needs to act as a fiduciary for the ex-spouse well after the divorce is finalized.

There are fundamentally two ways to value the options. One is known as the intrinsic value that simply measures the difference in price between the strike price and the value as of the date of divorce. This is very simple and may significantly undercut the other valuation method known as the Black Scholes pricing model. Black Scholes factors in various features of the option such as strike price, time to maturity, current price and historical price volatility, all of which are adjusted by a risk free rate of return, namely the rate on a 30-year Treasury. Google provides the daily volatility for any publicly traded stock and this number can be inserted into a Black-Scholes calculator. An option on a

stock with nice historical appreciation would generate a significantly higher Black-Scholes value than an intrinsic value, and particularly for large awards this differential can be very significant. In other words, it is important to appreciate the impacts and distinctions between the two valuation methodologies. A spouse who seeks to minimize the valuation of options for a stock with good appreciation potential would argue for the intrinsic value method. However, the other spouse would want to negotiate a valuation based on Black Scholes. In valuing stock options, particularly if the value will be used to offset other aspects of the property settlement, it is important to calculate using both methods as this can represent a big bargaining chip for negotiations.

E) Marital versus Non-Marital Calculations:

Stock options that were granted and vested during the marriage are clearly marital property. The challenge is valuing options that were granted during the marriage, but vest after the date of divorce. A time formula or coverture fraction is usually applied to determine the marital share. Other than options which are provided to a new employee as incentive to join the corporation, the formula used to establish the marital portion is known as the Nelson formula to reference the case from which it derived. The formula is as follows: the number of months between the date of the grant and the date of the divorce is divided by the number of months between the date of the grant and the date of exercisability. Then this fraction is multiplied by the number of shares which can be exercised, and that ratio represents the number of options which are marital property, which can either be exercised or used for purposes of offsetting the value of other marital property.

F) Mechanics:

If the non-employee spouse wishes to exercise the stock purchase when the option vests and hold onto the shares, and the plan does not allow for direct transfers of the options, then (s)he would have to have adequate cash to provide to the employee spouse to effectuate the purchase. The shares could then be transferred to the non-employee spouse. Alternatively, the employee spouse could exercise and sell the options simultaneously on behalf of the non-employee spouse. However, under both scenarios, there will have to be some remuneration to the employee spouse to account for the tax consequence resulting from the exercise. Therefore, the employee spouse may need to exercise more shares than (s)he will transfer to the non-employee spouse in order to gross up the associated tax liability. If a settlement agreement makes reference to the number of shares that the non-employee spouse may exercise based on the non-employee's shares of the marital portion of the stock options, but does not make reference to how the tax ramifications of that exercise should be treated, then such ambiguity will result in problems, potential post-divorce litigation, and a tax nightmare. In addition to the settlement agreement providing clarification regarding the tax consequences of exercising the stock options on behalf of the non-employee spouse, it should also specify that the employee spouse must provide the non-employee spouse with all vesting schedules, statements, and exercise options. The agreement should also put the burden on the non-employee spouse upon vesting to send written request to the employee spouse to request action. Stock options can represent a significant portion of a marital estate. It is essential to understand how such options can be valued as well as to document the rights and responsibilities associated with maintaining this asset.

G) Disclaimer:

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