

Are stocks options assets or income? It all depends ...

By Marc D. Bello



When is a stock option an asset and when is it income? That's become a hot topic among Massachusetts divorce lawyers thanks to a pair of two court

rulings that come down on opposite sides of the question.

When it comes to complex compensation packages, the importance of understanding the mechanics, purpose and nature of stock options should not be overlooked. The ability for divorcing couples to properly determine the role a stock option plays is pivotal in both the division of marital assets and/or a mechanism for future support.

Stock options allow an employee the right to buy company stock in the future at today's prices. Typically, an employee will have up to 10 years to exercise that right once the vesting period has expired.

Due to the fact that the stock option must be purchased by an employee, the first potential pitfall is identifying its existence, and second is determining if it

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has value. This can result in the option being overlooked as an asset or potential income.

Once the parties have an understanding of the stock options, the next question is how the options should be treated. Until recently, Massachusetts courts viewed stock options as a marital asset. Now, two seemingly conflicting Massachusetts court opinions have cast uncertainty on the issue.

The cases offer guidance from two different perspectives on how stock options can be handled in divorce. In one case, stock options are considered as a marital asset to be divided at the time of divorce. In the other, the exercise and sales of the options are viewed as income and are subject to alimony.

In some cases, the seemingly technical difference between the two approaches can add up to hundreds of thousands of dollars.

'Baccanti' vs. 'Wooters'

In 2001, the Supreme Judicial Court ruled that stock options were a marital asset in the widely cited case *Baccanti v. Morton*. The principle of the case was that stock options should be divided between divorcing spouses, with non-vested options apportioned according to a vesting percentage.

The options to be allocated as part of the division of assets were granted before the divorce in *Baccanti*. Even though the value of the options was uncertain, the right to buy existed and thus was dividable as an asset as part of a divorce settlement.

According to the ruling, the husband

could exercise his options and provide the wife with half the net gain. If he decided not to exercise his options, he could notify the wife of his decision and allow her to exercise her share through him.

In 2009, however, *Wooters v. Wooters* opened the door to a different interpretation. In that case, the husband was a partner at a law firm who reported fluctuating annual income. In determining alimony, the agreement gave the wife one-third of her ex-husband's future gross income. It should also be noted that, at the time of the divorce, stock option awards did not exist.

After the divorce, the husband went to work for a new company that provided him with stock options. When he exercised and sold those options for a substantial profit 12 years after the divorce, the gains created by sale of the options showed up as income on his W-2, boosting his gross pay to nearly \$1.2 million. The ex-wife claimed a one-third share under the terms of the original divorce settlement.

The judge ruled for the ex-wife, and the Appeals Court agreed, finding that the husband's exercised stock options fell within the definition of "gross annual employment income" and were therefore subject to the alimony agreement.

In issuing its ruling, the Appeals Court cited cases in other states — including Arizona, Illinois, California, Florida, New Hampshire and Ohio — where exercised stock options were considered income for the purposes of either child support or alimony.

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contradictory Massachusetts rulings, lawyers now find themselves trying to puzzle out the circumstances under which interpretation might apply.

Stock options are a unique benefit awarded employees. One question to consider is whether the stock option award was granted to subsidize an employee's annual cash earnings such as salary or bonus, or as an additional incentive to attract and retain an employee?

Second, a stock option is designed as an award that grants the employee the future right to purchase the stock with his own money, at his discretion, based on the company's stock price as of the date of the award.

Understanding those two points can help guide divorcing couples in determining how to treat stock options.

As *Baccanti* and *Wooters* show, options identified at the date of divorce can be treated as an asset and/or morph into income depending on timing, method of exercise and profitability of the transaction — issues that should be considered in the midst of negotiating a divorce settlement.

For example, what would the ruling in *Wooters* have been if the stock options had been granted during the marriage? Would the options have been considered

an asset, precluding their eventual inclusion in future gross employment income?

What if the husband had immediately exercised his options, purchasing them with his own money at their initial strike price? That would have converted any eventual appreciation of the stock into a capital gain instead of employment income reported on his W-2.

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Minimizing future problems

To help shed light on the appropriate way to treat a stock option, one might take a look at a similar but different type of non-compensatory plan that grants restricted stock units.

A restricted stock unit is an award to an employee, and when it vests the employee takes ownership of the stock. The distinction in how an employee takes ownership can and should be correlated to treating the grant of stock as a marital asset or as income.

For example, a restricted stock that vests annually could be considered stock compensation in lieu of salary, whereas the increase in appreciation of the stock option (even though a potential gain may be recognized in wages) upon its sale could be considered a return on an investment rather than compensation.

Failure to understand and properly address those issues could leave divorcing

parties open to future litigation due to perceived misconceptions. As the *Baccanti* and *Wooters* rulings make clear, attorneys negotiating divorce settlements need to pay close attention to the timing of the options, the nature of the stock grant, and what the owner actually

does with the option.

By specifying exactly how stock options will be treated, even if no such stock options exist at the time of divorce, attorneys can proactively minimize future problems.

The Appeals Court in *Wooters* makes that point clearly, with the judge noting that the parties could have restricted the definition of “gross annual employment income” at the time of divorce if they had wished to do so. Those who fail to do so now when negotiating a settlement may come to wish that they had. **MLW**

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