

# Notice of Proposed Rules Regarding Employment Taxation of Transfers Incident to Divorce

## Notice 2002-31

### I. Overview and Purpose

This notice sets forth the contents of a proposed revenue ruling explaining how the Federal Insurance Contributions Act (FICA), the Federal Unemployment Tax Act (FUTA), and the Collection of Income Tax at Source on Wages (income tax withholding) apply to a transfer of interests in nonstatutory stock options and nonqualified deferred compensation to a former spouse incident to a divorce. The proposed revenue ruling also contains proposed reporting requirements with respect to such transferred interests.

This notice solicits comments regarding the proposed revenue ruling. The Department of the Treasury and the Internal Revenue Service anticipate issuing a final revenue ruling after the comments have been considered.

### II. Proposed Revenue Ruling

The facts in the proposed revenue ruling below are the same as in Rev. Rul. 2002-22, page 849, this Bulletin, and are restated here for convenience.

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#### PROPOSED REVENUE RULING

#### ISSUES

(1) What is the effect upon taxation under the Federal Insurance Contributions Act (FICA), the Federal Unemployment Tax Act (FUTA), and the Collection of Income Tax at Source on Wages (income tax withholding) of a transfer of interests in nonstatutory stock options and nonqualified deferred compensation to a former spouse incident to divorce?

(2) What is the appropriate reporting of income and/or wages recognized with respect to nonstatutory stock options and

nonqualified deferred compensation transferred to a former spouse incident to divorce?

#### 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 section 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, 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 section 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* trans-

ferred 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 \$75*x* 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 \$25*x* from *Y* under the other deferred compensation plan upon *A*'s termination of employment with *Y*.

In 2006, *B* exercises all of the transferred 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 \$150*x* from the account balance plan and a single sum payment of \$25*x* from the other deferred compensation plan.

#### LAW AND ANALYSIS

Rev. Rul. 2002-22, page 849, concludes that 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. The ruling also concludes that the former spouse, rather than 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.

#### FICA Wages

Sections 3101 and 3111 impose FICA taxes on "wages" as that term is defined in section 3121(a). FICA taxes consist of the Old-Age, Survivors and Disability Insurance tax (social security tax) and the Hospital Insurance tax (Medicare tax). These taxes are imposed on both the employer and employee. Sections 3101(a) and 3101(b) impose the employee portions of the social security tax and the Medicare tax, respectively. Sections 3111(a) and (b) impose the employer portions of the social security tax and the Medicare tax, respectively.

Section 3102(a) provides that the employee portion of FICA taxes must be collected by the employer of the taxpayer by deducting the amount of the tax from wages as and when paid. Section 31.3102(a)-1(a) of the Employment Tax Regulations provides that the employer is required to collect the tax, notwithstanding that wages are paid in something other than money. Section 3102(b) provides that every employer required to deduct the FICA employee tax is liable for the payment of that tax, and is indemnified against the claims and demands of any person for the amount of any such payment made by such employer.

The term “wages” is defined in section 3121(a) for FICA purposes as all remuneration for employment, including the cash value of all remuneration (including benefits) paid in any medium other than cash, with certain specific exceptions. Section 3121(b) defines “employment” as any service, of whatever nature, performed by an employee for the person employing him, with certain specific exceptions.

Section 31.3121(a)-1(e) of the regulations provides that in general the medium in which the remuneration is paid is immaterial. It may be paid in cash or other than in cash. Remuneration paid in any medium other than cash is computed on the basis of the fair market value of such items at the time of payment.

Under section 3121(v)(2), amounts deferred under a nonqualified deferred compensation plan generally are to be taken into account when the services are performed or, if later, when there is no substantial risk of forfeiture. To the extent benefit payments under a nonqualified deferred compensation plan are attributable to amounts deferred under the plan that have been taken into account for FICA tax purposes, the benefit payments are not treated as FICA wages. To the extent benefit payments are attributable to an amount deferred that has not been taken into account for FICA tax purposes, then the benefit payments are treated as FICA wages. *See* section 31.3121(v)(2)-1(d)(1)(ii) of the regulations.

In the Social Security Amendments of 1983, Public Law No. 98-21 (1983-2 C.B. 309), Congress added language to section 3121(a) providing that nothing in the income tax withholding regulations

that provides an exclusion from wages for income tax withholding purposes shall be construed to require a similar exclusion from wages for FICA purposes. The legislative history in connection with this provision states that “[s]ince the [social] security system has objectives which are significantly different from the objective underlying the income tax withholding rules, the committee believes that amounts exempt from income tax withholding should not be exempt from FICA tax unless Congress provides an explicit tax exclusion.” S. Rep. No. 23, 98th Cong., 1st Sess. at 42 (1983).

The fact that payments are includible in the gross income of an individual other than an employee does not remove the payments from FICA wages. *See* Rev. Rul. 71-116 (1971-1 C.B. 277) holding that payments of wages to an employee in a community property state are FICA wages although one-half of the wages is includible in the gross income of the non-employee spouse. *See also* Rev. Rul. 86-109 (1986-2 C.B. 196) which holds that payments of remuneration for employment made after the death of an employee and in the calendar year of the death are wages for FICA tax purposes, although the amounts are includible in the gross income of the recipient and not the employee.

Rev. Rul. 2002-22 holds that, upon the exercise of nonstatutory stock options obtained by a nonemployee spouse pursuant to divorce, the property transferred to the nonemployee spouse by the employer has the same character and is includible in the income of the nonemployee spouse under section 83(a) to the same extent as the property would have been includible in the income of the employee spouse had the options been retained and exercised by the employee spouse. Rev. Rul. 2002-22 further holds that nonqualified deferred compensation, the right to which is obtained by a nonemployee spouse pursuant to divorce, paid or made available to the nonemployee spouse has the same character and is includible in the income of the nonemployee spouse to the same extent as the compensation would have been includible in the income of the employee spouse had the compensation been paid or made available to the employee spouse. Nothing in section 1041 excludes payments to a person other

than an employee from wages for purposes of FICA. In the absence of a specific provision that would exclude these payments from FICA wages, the compensation realized on the exercise of the stock options by the nonemployee spouse and the deferred compensation paid or made available to the nonemployee spouse retain their character as wages of the employee spouse for purposes of FICA. Thus, the payment of such remuneration is subject to FICA to the same extent as if paid to the employee spouse.

Accordingly, the nonqualified deferred compensation paid or made available to the former spouse remains subject to the rules of section 3121, including section 3121(v) and the regulations thereunder, to determine when and whether FICA tax is applicable. Thus, to the extent the amount deferred has been previously taken into account for FICA purposes, the distribution to the former spouse of the proceeds of the account balance plan would not be treated as wages for FICA tax purposes. However, to the extent the amount deferred has not been previously taken into account for FICA tax purposes, the distribution to the former spouse of the proceeds of the account balance plan would be wages of the employee for FICA tax purposes. Similarly, under section 3121 and the regulations thereunder, a former spouse’s exercise of nonqualified stock options results in FICA wages of the employee to the extent that the fair market value of the stock received pursuant to the exercise of the option exceeds the option exercise price.

To the extent the distributed payments are FICA wages, the employee FICA tax is deducted from the payment made to the transferee. The amount includible in the gross income of the transferee is not reduced by any FICA withholding from the payments (including transfers of property) to the transferee. *See* Rev. Rul. 86-109 and Rev. Rul. 71-116.

Because *A* was the service performer and the remuneration relates to *A*’s service in employment with *Y*, the wages, although paid to *B*, are FICA wages of *A*. *See* Rev. Rul. 71-116. Thus, because the payments are wages for FICA tax purposes, the payments are reportable by *Y* as social security wages and Medicare wages on a Form W-2, *Wage and Tax Statement*, issued for *A*, and the social

security tax withheld and Medicare tax withheld are also reportable on the Form W-2 for A. Y may take into account other wages previously paid to A in that calendar year in determining whether these distributions are excepted from social security wages under section 3121(a)(1), the maximum social security wage base exception. Finally, these payments should not be included in Box 1, Wages, tips, other compensation, nor should any amount be reflected in Box 2, Federal income tax withheld, of the Form W-2 issued to A with respect to these payments.

### FUTA

The FUTA taxation provisions applicable with respect to nonqualified stock options and nonqualified deferred compensation plans are similar to the FICA provisions, except that only the employer pays the tax imposed under FUTA. See sections 3301, 3306(b), and 3306(r)(2) and the regulations thereunder. Because of the similar statutory provisions, FUTA taxation applies at the same time and in the same manner as FICA. To the extent wage taxation applies, the wages are FUTA wages of the employee A, subject to the maximum wage base contained in section 3306(b)(1). As with FICA, wages previously paid to the employee during the calendar year may be taken into account in determining whether these amounts qualify for the FUTA maximum wage base exception.

### Income Tax Withholding

Section 3402(a) of the Code, relating to income tax withholding, generally requires every employer making a payment of wages to deduct and withhold upon those wages a tax determined in accordance with prescribed tables or computational procedures.

Section 3401(a) provides that “wages” for income tax withholding purposes means all remuneration for services performed by an employee for his employer, including the cash value of all remuneration (including benefits) paid in any medium other than cash, with certain exceptions not pertinent to this ruling.

Under section 31.3402(a)-1(c) of the regulations, an employer is required to

deduct and withhold the tax notwithstanding that the wages are paid in something other than money (for example, wages paid in stock or bonds) and to pay over the tax in money. If the wages are paid in property other than money, the employer should make necessary arrangements to insure that the amount of the tax required to be withheld is available for payment in money.

Section 31 provides that the amount withheld from wages as income tax withholding will be allowed to the “recipient of the income” as a credit against the income taxes imposed by Subtitle A. Section 1.31-1(a) of the Income Tax Regulations provides that the “recipient of the income” for purposes of the section 31 credit is the individual who is subject to income taxes upon the wages from which the tax was withheld. For example, if an employee spouse and nonemployee spouse are domiciled in a community property state and file separate income tax returns, each reporting for income tax purposes one-half of the wages received by the employee spouse, each spouse is entitled to one-half of the credit allowable for the tax withheld at the source with respect to the wages.

Because the compensatory interests transferred under section 1041 to the nonemployee spouse pursuant to the divorce remain taxable for employment tax purposes to the same extent as if retained by the employee spouse, the income recognized by the nonemployee spouse with respect to the exercise of the nonqualified stock options and the distributions from the nonqualified deferred compensation plans are remuneration for employment and wages for purposes of income tax withholding under section 3402. Pursuant to section 1.31-1(a) of the regulations, because the income recognized with respect to this compensation is includible in the gross income of the nonemployee spouse, the nonemployee spouse is entitled to the credit for the income tax withheld with respect to these wage payments.

### Reporting of payments

Section 6051 requires payors of remuneration to an employee to report those payments on Form W-2, *Wage and Tax Statement*. Because the former spouse is

not an employee, the reporting requirements of section 6051 do not apply.

Section 6041(a) requires that all persons engaged in a trade or business who make a payment to a third party during the course of such business must file a return with the IRS, reporting all payments totaling \$600 or more in a taxable year, of rent, salaries, wages, premiums, annuities, compensations, remunerations, emoluments, or other fixed or determinable gains, profits and income. In this case, pursuant to section 6041(a), Y must file an information return reporting both the income B realized from B's exercise of the nonstatutory stock options and the payments made to B from the deferred compensation plans.

Under section 31.6051-1(a)(1) of the regulations, the wages of an employee that are subject to social security and Medicare taxes are included in the appropriate boxes on the Form W-2 issued to the employee. See also Rev. Rul. 71-116.

Because there is no provision for the issuance of Form W-2 in the name of a nonemployee spouse, the income realized upon the exercise of the nonqualified stock options would be reportable to the nonemployee spouse by Y on Form 1099-MISC, *Miscellaneous Income*, issued to the nonemployee spouse, in Box 3, Other Income, with the income tax withheld reported in Box 4, Federal income tax withheld. The payments to the nonemployee spouse B from the nonqualified deferred compensation plans and the withholding thereon would also be reportable by Y on a Form 1099-MISC in Box 3, with the income tax withheld reported in Box 4.

Social security wages, social security tax withheld, Medicare wages, and Medicare taxes withheld, if applicable, are reported on the employee spouse's Form W-2 as described above.

Employers would report the income tax withholding on wages paid to the nonemployee spouse on Form 945, *Annual Return of Withheld Federal Income Tax*. The social security and Medicare tax paid with respect to these wages of the employee spouse would be reported on Form 941, *Employer's Quarterly Federal Tax Return*. FUTA tax with respect to wages of the employee spouse would be reported on Form 940, *Employer's Annual Federal Unemployment Tax Return*.

## HOLDINGS

(1) The transfer of interests in non-statutory stock options and nonqualified deferred compensation from the employee spouse to the nonemployee spouse incident to divorce does not result in a payment of wages for FICA and FUTA tax purposes.

The nonstatutory stock options are subject to FICA and FUTA taxes at the time of exercise by the nonemployee spouse to the same extent as if the options had been retained by the employee spouse and exercised by the employee spouse. The nonqualified deferred compensation also remains subject to FICA and FUTA taxes to the same extent as if the rights to the compensation had been retained by the employee spouse. To the extent FICA and FUTA taxation apply, the wages are the wages of the employee spouse. The employee portion of the FICA taxes is deducted from the wages as and when the wages are taken into account for FICA tax purposes.

The income recognized by the nonemployee spouse with respect to the exercise of the nonqualified stock options is subject to withholding under section 3402. The amounts distributed to the nonemployee spouse from the nonqualified deferred compensation plans are also subject to withholding under section 3402. Pursuant to section 31, the nonemployee spouse is entitled to the credit allowable for the income tax withheld at the source on these wages.

(2) The social security wages, Medicare wages, social security taxes withheld, and Medicare taxes withheld, if applicable, are reportable on a Form W-2 with the name, address, and social security number of the employee spouse. However, no amount is includible in Box 1 and Box 2 of the employee's Form W-2 with respect to these payments. The income with respect to the exercise of the nonqualified stock option by the nonemployee spouse and the distributions from the nonqualified deferred compensation plans to the nonemployee spouse are reportable in Box 3 as other income on a Form 1099-MISC with the name, address, and social security number of the nonemployee spouse. Income tax withholding with respect to these payments of

wages is included in Box 4, Federal income tax withheld.

Income tax withholding on payments to the nonemployee spouse is included on a Form 945 filed by Y. The social security tax and Medicare tax is reported on Y's Form 941, and the FUTA tax is reported on Y's Form 940.

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### III. Request for Comments

Comments are requested regarding the proposed FICA, FUTA, income tax withholding, and reporting obligations with respect to transfers of interests in non-statutory stock options and nonqualified deferred compensation incident to divorce. All comments will be available for public inspection and copying. Comments must be submitted by July 15, 2002. Comments should reference Notice 2002-31, and be addressed to:

Associate Chief Counsel  
(Tax Exempt and Government  
Entities)  
CC:TEGE  
Attn: Employment Taxation of  
Transfers Incident to Divorce  
Room 5214  
Internal Revenue Service  
1111 Constitution Ave., N.W.  
Washington, DC 20224

In addition, comments may be submitted electronically via the Internet by sending them in an e-mail to [notice.comments@irscounsel.treas.gov](mailto:notice.comments@irscounsel.treas.gov) and specifying the comments concern Notice 2002-31.

### IV. Proposed Effective Date of Proposed Revenue Ruling

It is proposed that the revenue ruling described above be effective January 1 of the calendar year beginning not less than 120 days after the publication of the conclusions proposed in this notice as a revenue ruling or other document. For periods before the effective date, it is expected that the revenue ruling will provide relief to employers for reasonable, good faith interpretations, including the interpretation in the proposed revenue ruling. However, with respect to compensation that is transferred to a spouse incident to divorce, it is expected that failure

to treat nonqualified stock option compensation, or amounts deferred under a nonqualified deferred compensation plan, as subject to FICA will not be considered a reasonable, good faith interpretation.

### Drafting Information

The principal author of this notice is A. G. Kelley of the Office of the Associate Chief Counsel (Tax Exempt and Government Entities). However, other personnel from Treasury and the Service participated in its development. For further information regarding this notice, contact A. G. Kelley at (202) 622-6040 (not a toll-free call).