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THE TRANSFER OF NONQUALIFIED DEFFERRED
COMPENSATION AND NONSTATUTORY STOCK
OPTIONS: The Interaction of the Assignment of Income
Doctrine and Internal Revenue Code §1041?

By:

Vincent R. Barrella*

I. INTRODUCTION:

The assignment of income doctrine is one of the oldest
and most consistently applied of all of the common law
doctrines. Its origins clearly demonstrate that the presence or
absence of tax avoidance as a reason for the anticipatory
division of income is not a controlling factor in the doctrine’s
application.1 So long as the assignor is willing to surrender
part of the “tree” (property) he can assign the “fruit” (income)
produced from that portion of the tree. What generally can not
be done is to assign all or a part of the fruit without transferring
that portion of the tree which produces the fruit.2 Thus, income
from property can readily be assigned, provided, that the
transferor is willing to transfer to the assignee an interest in the
property producing the income.3

The rules relating to the assignment of income derived
from the rendering of services are much more restrictive. In
that case, the “tree” producing the “fruit” is the person
providing the services. As it is impossible for a taxpayer to
transfer all or part of himself to another person, earned income
can not be assigned from one taxpayer to another unless the
decision is overridden or otherwise rendered inapplicable.

Furthermore, the fact that a taxpayer need not render any
additional services in subsequent years (i.e., the income is fully
earned), does not alter that result.4 There are, however,
judicial and statutory exceptions to the application of the
doctrine. For example, in the domestic relations arena sections
71 (defining alimony) and 215 (allowing a deduction for
alimony paid) effectively override the doctrine.

Property settlements proved to be somewhat trickier in
light of the different state law provisions regarding interests in
property (i.e., common law v. community property rules). One
of the more nettlesome decisions was the Supreme Court’s
opinion in United States v. Davis.5 In 1984, Congress
revamped the rules governing the treatment of alimony. In
addition, it enacted section 1041 to alleviate some of the
problems relating to property settlements. Section 1041
reverses the result in Davis by shifting the incidence of taxation
from the transferor of property to the transferee.6 Critical to
the operation of section 1041 is a transfer of property.7 In
the case of qualified deferred compensation, Congress provided for
income shifting through the mechanism of a “qualified
domestic relations order,” which allows for a former spouse
(the transferee) to be characterized as an “alternative payee.”8
There is no parallel provision addressing the consequences of a
transfer of nonqualified deferred compensation incident to a
divorce.

II. REV. RUL. 2002-22

In an effort to fill that void, the Internal Revenue
Service (“Service”) issued Rev. Rul. 2002-229 wherein it set
forth the position that section 1041 treatment should be
extended to nonqualified deferred compensation and

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nonstatutory stock options. In the context of transfer incident to a divorce, the Service has effectively put nonstatutory stock options and nonqualified deferred compensation on par with statutory options and qualified deferred compensation. While it is anticipated that the Service’s decision will more often than not produce favorable results, a question lingers as to whether the Service’s position is justified from a purely technical point of view. For example, in the case of qualified deferred compensation, the seamless dovetailing with section 1041 is accomplished through other statutory provisions. The desire to achieve symmetry is admirable; but will the Service’s efforts withstand scrutiny?

The linchpin of the Service’s effort to extend section 1041 treatment to nonstatutory stock options and nonqualified deferred compensation through Rev. Rul. 2002-22 is the characterization of the transferor’s interest in both as property. Once the Service concluded that these interests constituted property, it followed that section 1041 could apply to a transfer of either incident to a divorce. Regardless of whether the Service should have moved away from its original position regarding the primacy of the assignment of income doctrine, the ruling provides some significant opportunities for the transferor spouse and places an additional burden on the transferee spouse. For example, a taxpayer who is entitled to a significant future payment for previously provided services can avoid the limitations applicable to the deductibility of alimony by structuring the payout as a transfer of his right to the nonqualified deferred compensation.

The impact of Rev. Rul. 2002-22 can be illustrated by the following. Assume that at the time of their divorce, H has a vested interest in an unfunded and unsecured nonqualified deferred compensation account. Assume further that under the terms of their 2002 divorce decree W is entitled to receive fifty percent of the balance in said account and that in the event that W should die prior to the date of payment of the deferred compensation, said amount is to be paid to her estate. In 2006, W receives $200,000 which represents her share of the balance in H’s deferred compensation account at the time of their divorce.

Prior to the issuance of Rev. Rul. 2002-22, H would have recognized $400,000 of income from deferred compensation in 2006, but would have retained only $200,000 since W would have received one-half of the $400,000. H would not be entitled to an alimony deduction pursuant to section 215, because the payment to W would not meet the section 71 definition of alimony. Absent characterization as alimony, the payment would be in the nature of a property settlement. Neither H nor W would recognize any gain on the transfer of the $200,000. If we assume that H is taxed at the rate of thirty (30) percent on his receipt of the $400,000, the applicable tax liability would be $120,000 leaving him with only $80,000 (or approximately 29% of the after tax payment) while W ends up with $200,000 (or approximately 71% of the after tax payment).

If under the terms of the divorce decree, the payment would not have survived W’s death, and none of the other limitations on the characterization of the payment as alimony were applicable, H may still suffer adverse consequences. For example, if H resides in a state that imposes a tax on gross income he would not derive any benefit from the alimony deduction. Consequently, he would be subject to tax on the full $400,000. If W resided in the same state, she would be taxed on the $200,000 of alimony she received. Thus, $400,000 would be taxed as the state level as though it were $600,000. Rev. Rul. 2002-22 remedies this situation since under the Service’s analysis only the net amount of $200,000
would be included in H’s gross income, with the remaining $200,000 includible directly in W’s gross income.

In its ruling, the Service concludes that section 1041 can override the assignment of income doctrine. There is nothing remarkable or controversial about this position. The problem is that in order for section 1041 to be applicable there must be a transfer of property or rights to property. 18 The difficulty with the Service’s analysis is that what is being transferred is the right to receive earned income (i.e., income relating to services provided by the taxpayer). It remains to be seen whether the courts will agree with the Service that this constitutes a property right within the purview of section 1041. Compounding this problem is the fact that Congress, by providing for the inclusion of alimony by the recipient and its deduction by the payor, has provided a mechanism to shift earned income between taxpayers.

III. THE DIFFERING TREATMENT OF NON-VESTED v. VESTED RIGHTS

The Service specifically provided circumstances under which the ruling would not be applicable. One of these situations is where, at the time of the transfer, the transferor’s rights are unvested or subject to substantial contingencies. 19 The Service’s refusal to extend the treatment it is willing to accord vested nonqualified deferred compensation or nonqualified stock options to similar but non-vested situations raises additional questions.

The impact of the Service’s refusal can be illustrated utilizing the facts set forth above, with one additional fact; that H’s right to the deferred compensation did not vest unless he remained an employee of the plan sponsor for a period of four years following the year in which the deferred compensation was otherwise earned. Under this circumstance, the Service would refuse to apply Rev. Rul. 2002-22 and would instead apply assignment of income principles thus taxing H on the receipt of the entire payment. H would suffer the adverse consequences set forth above, which the Service willing eliminated in the case of vested nonqualified deferred compensation. The Service never explained why this restrictive approach does not frustrate the purpose of section 1041. The Service also did not offer any reason for its decision to restrict the scope of its ruling in this manner, for example, what potential abuse did it envision occurring? Instead it relied on the Ninth Circuit’s opinion in Kochansky v. Commissioner. 20

Kochansky is, however, inapposite. At issue in that case was an attempt by an attorney to transfer to his former spouse one-half of a net contingency fee from a specific case that was yet to be resolved. Subsequent to their divorce he settled the case, and the fee was paid to him and his former wife consistent with the terms of the divorce decree. The application of section 1041 was not at issue in Kochansky. The Service’s argument, and the Court’s analysis, proceeded entirely along assignment of income lines. 21

The Service’s restrictive position is seemingly predicated upon its view that a contingent right does not give rise to property. Query whether this is inconsistent with the Congressional mandate to construe that term property broadly when applying section 1041 so as to facilitate transfers incident to a divorce? Insight into the Service’s thought process can be obtained by examining the exclusion of “other future income rights” from section 1041 treatment. Indeed that is precisely the type of income interest addressed by the Ninth Circuit in Kochansky. A better approach would have been for
the Service to limit the scope of the ruling to deferred compensation and stock options; while at the same time making it clear that "other future income rights," whether vested or non-vested, are outside of the scope of section 1041 where those rights relate to earned income.22

Within the context of a divorce there is little practical difference between the a division of a taxpayer’s vested right to receive deferred compensation and a right that will vest provided the taxpayer continues to be employed by the same employer for a period of time. Applying the assignment of income doctrine in either situation would frustrate the purpose of section 1041. This is especially true given the level of specificity that the courts have demanded before shifting the burden from the transferor of property to the transferee.23 Rev. Rul. 2002-22 notwithstanding, it appears unlikely that a court will impose the additional burden on the transferee absent a clear language in the divorce decree that the imposition of this burden was intended by the parties.

In the case of nonstatutory options, this intent can be easily established through the actual transfer of said options. Assuming that the options can be transferred, the absence of an actual transfer should generally preclude the application of Rev. Rul. 2002-22. With respect to deferred compensation arrangements, to the extent that a taxpayer can assign or transfer his or her rights to said compensation, he or she should be required to do so before being able to apply the rationale of the ruling. Thus, the employer should be making payments directly to the transferee former spouse. The more difficult situation arises where the plan provides that the taxpayer's interest in the deferred compensation can not be transferred or assigned. In that case, payments are made to the employee who then makes a payment to his former spouse. In order for transferor to reap the benefit of shifting the tax burden to the transferee, the divorce decree should contain language clearly delineating that the parties intended this result.

IV. CONCLUSION

The Service’s willingness to permit divorcing spouses to shift earned income outside the parameters of a traditional alimony deduction provides taxpayers and their advisors with a significantly enhanced degree of flexibility. In order to take advantage of this flexibility it is imperative that the rights and obligations of the parties be clearly set forth. A court confronted with determining whether Rev. Rul. 2002-22 should be applied to shift the incidence of taxation from the transferor spouse to the transferee spouse should not be left to guess as to the party’s intent. This is particularly important since it is unclear whether the result reached under Rev. Rul. 2002-22 is the correct one.

ENDNOTES

1 Lucas v. Earl, 281 U.S. 111 (1930). The assignment of income at issue in Earl arose as a consequence of an agreement entered into years before the enactment of the income tax in 1913. Thus, there was no question that tax avoidance motive was a motivating factor in the income splitting arrangement.

2 An exception to this general rule is found in Blair v. Commissioner, 300 U.S. 5 (1937). Blair involved a situation wherein the transferor did have any interest in the underlying property producing the income (i.e., his interest was solely that of an income beneficiary). The taxpayer assigned a portion of his right to receive income to a third party. Holding that he transferred a
portion of everything he had, the Court allowed the transfer and refused to apply the assignment of income doctrine.

3 See, Helvering v. Horst, 311 U.S. 112 (1940). The transferor need not transfer his entire interest in property to another in order to effectuate an assignment of income; however, that which he transfers must include an ownership interest in the property itself as opposed to simply the income to be produced from the property.

4 See, e.g., Helvering v. Eubank, 311 U.S. 122 (1940), reh. denied, 312 U.S. 713 (1941), wherein the taxpayer sought to assign the income from insurance renewal commissions. These commissions required no further activity by the taxpayer. Despite this, the renewal commissions did not lose their status as earned income, so as to allow them to be characterized as property, or fit within the more liberal approach of Blair. See, note 2, supra.

5 370 U.S. 65 (1962), reh. denied, 371 U.S. 854 (1962). The Davis opinion complicated matters concerning property settlements by imposing an additional cost upon the transferee spouse in the form of a tax liability based upon the appreciation in the asset transferred in exchange for the transferee spouse's marital rights. This additional cost, however, was generally a burden only in common law states, since the joint ownership interest in community property states eliminated much of the problem.

6 Section 1041 accomplishes this by treating the transfer as a gift and by providing that the transferee takes a carryover (the transferor's basis) in the property. See, §1041(b)

7 Also essential to any analysis is a determination of the nature of the interest transferred in connection with the divorce. That is, was an interest in property subject to gain or loss transferred, or was the property being transferred simply the proceeds from the subsequent sale of the property? See, text accompanying note 23, infra. The answer to this question is vitally important in determining the appropriate tax consequences of a property transfer governed by section 1041.

8 See, Section 414(p)


10 This represented a reversal of the Service's previous position, that the assignment of income doctrine controlled the outcome in this area. Examples of the Service's more restrictive approach can be found in FSA 200005006, 2/4/2000 (involving nonstatutory stock options) and PLR 9340032, 7/6/1993 (involving nonqualified deferred compensation).

11 See, note 8, supra.

12 Congress intended that in applying section 1041, the term property be broadly construed so as to ease the burden associated with transfers in connection with a divorce. Balding v. Commissioner, 98 T.C. 368, 371 (1992); see also, H.R. Rep. No. 432, 98 Cong., 2d Sess. 1491, 1492 (1984)

13 Under Rev. Rul. 2002-22, the deferred compensation which is assigned to his former spouse never comes into his income; therefore, sections 71 and 215 relating to the characterization and deductibility of alimony are inapplicable.

14 The fact that the W's right to receive the applicable percentage of H's deferred compensation survives her death would preclude the treatment of the payment of said sum as alimony. See, §71(b).

15 This would be true even if H received property from his employer instead of cash. The property would be included in his gross income at its fair market value and he would take as his basis in said
property that same amount. Section 1041 would protect both H and W upon the transfer of the property, and W would take H’s basis in the property. Thus, if W were to immediately sell the property for its fair market value, W would not recognize any gain or loss.

16 The adverse tax effect could be exacerbated if any of the limitations based upon gross income or adjusted gross income where triggered. See, e.g., §165(b)(2) relating to the limitation on the deductibility of a casualty loss. In addition, H would be liable for any applicable FICA tax applicable to the $400,000 payment.

17 See, e.g., §71(b) and §71(f)

18 See, §1041(b)

19 The ruling specifically provides that it “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.”

19 92 F.3d 957 (9th Cir. 1996)

20 Based upon the manner in which the case was argued, had the matter giving rise to the fee been resolved and the taxpayer been entitled to receive a specific sum certain at the time of the divorce, it is unlikely that the Service or the Ninth Circuit would have reached a different result. However, had the taxpayer argued section 1041 and if the Service is correct, that vested future right to receive income from services gives rise to property, within the meaning of section 1041, then a division of a fee similar to the one at issue in Kochansky should be respected.

21 The Service cited a number of pre-section 1041 cases in support of principle that transfers between divorcing spouses were not voluntary assignments so as to trigger the application of the assignment of income doctrine. These cases – Meiner v. United States, 133 F.3d 654 (8 Cir. 1998) (transfer of a royalty interest);

Kenfield v. United States, 783 F.2d 966 (10 Cir. 1986) (transfer of a partnership interest); Schulze v. Commissioner, T.C.M. 1983-263 (transfer of an interest in a lawsuit); and Cofield v. Koehler, 207 F. Supp. 73 (D. Kan. 1962) (transfer of savings bonds) – did not involve the transfer of a right to receive earned income. It should be noted, however, that the lawsuit in Schulze was brought in part to recover partnership income, but that was but one aspect of the overall claim assigned to the taxpayer’s former spouse. Moreover, the assignment of the interest in the lawsuit was part of an overall plan to divide the separately held property of the taxpayer and his former spouse.

21 See, e.g., Balding v. Commissioner, 98 T.C. 368 (1992) (wife was not required to include in her income payments received from former husband in lieu of her share of his military retirement pay); Witcher v. Commissioner, T.C. Memo 2002-292 (wife had to include portion of husband’s military retirement pay paid directly to her pursuant to a state court award); Yankwich v. Commissioner, T.C. Memo 2002-37 (court refused to tax transferee spouse on gain from an installment sale; separation agreement did not transfer beneficial interest in the obligation to the transferee); Weir v. Commissioner, T.C. Memo 2001-184 (transferee spouse taxed on receipt of payments made to her by her former husband; payments treated as former husband’s military pension in light of clear language in the agreement); Suhr v. Commissioner, T.C. Memo 2001-28 (court ordered award of one-half of the proceeds from the sale of a house did not constitute an award to him of an ownership interest in the property); Urbauer v. Commissioner, T.C. Memo 1997-227 (court refused to tax transferee spouse on gain from sale of house; transferee did not acquire a beneficial interest in the house by virtue of her interest in the sales proceeds); Friscone v. Commissioner, T.C. Memo 1996-193 (while legal title to shares of stock was not transferred, the divorce decree left no doubt that there was a transfer of the beneficial ownership of the stock).