

## Summary of Revenue Ruling 2004-60 on Option Transfers Incident to a Divorce

The IRS has recently addressed the effect upon employment taxes and employer reporting requirements regarding transfers of interests in nonstatutory stock options and nonqualified deferred compensation, or compensation, to former spouses incident to divorce.

### ***Employment Taxes***

#### ***employee v. nonemployee spouse***

The IRS has concluded that the mere transfer of interests in compensation from the employee spouse to the nonemployee spouse incident to a divorce does not result in the recognition of any income or the payment of wages for Federal Insurance Contributions Act (FICA) and Federal Unemployment Tax Act (FUTA) purposes. However, there are income, FICA and FUTA consequences when the compensation is actually received by the nonemployee spouse.

- The nonemployee spouse will have income when an option is exercised or deferred compensation or other income is paid but that income is not reduced by any FICA tax withholding.
- 
- Compensation so received is subject to FICA and FUTA taxes to the same extent as if the rights to the compensation had been retained by the employee spouse.

For example, at the time of exercise by the nonemployee spouse, the nonstatutory stock options are subject to FICA and FUTA taxes to the same extent as if the options had been retained and exercised by the employee spouse. Consequently, the income received by the nonemployee spouse from the stock options would be wages of the *employee spouse* for FICA tax purposes only.

- The employee spouse FICA tax should be deducted from any payments made to the nonemployee spouse.

### ***Tax Withholding***

The IRS has concluded that the income realized by the nonemployee spouse with respect to the compensation is subject to income tax withholding under Section 3402.

- The supplemental wage flat rate, currently 25%, may be used to determine the amount of income tax to withhold.

- The amounts to be withheld should be deducted from the **payments stock** made to the nonemployee spouse.
- The nonemployee spouse is entitled to the credit allowable for the income tax withheld.

### ***Reporting Requirements***

The IRS has concluded that because there is no provision for the issuance of a Form W-2 in the name of the nonemployee spouse, employers should issue a Form 1099-MISC to report the income realized and the income tax withheld from the transferred compensation. However, any Social Security and Medicare wages and taxes should be reported on the *employee* spouse's Form W-2.

- The income realized by the nonemployee spouse should be reported in Box 3 as "other income" on Form 1099.
- The nonemployee spouse's income tax withholding should be included in Box 4 as "Federal income tax withheld" on Form 1099.
- **No amount should be reported in Box 1 or Box 2 of the employee spouse's Form W-2 with respect to the transferred compensation.**
- The income tax withholding on compensation paid to the nonemployee spouse should be reported on Form 945.
- The Social Security and Medicare taxes should be reported on Form 941.
- The FUTA tax should be reported on Form 940.

### ***Prospective Application***

Revenue ruling 2004-60 is effective January 1, 2005.