
Divorce: Classifying, Valuing, and Dividing Executive Employment Benefits

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DIVORCE: CLASSIFYING, VALUING, AND DIVIDING EXECUTIVE EMPLOYMENT BENEFITS

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Overview:

Definition of Nonqualified Deferred Compensation

- The promise of compensation earned in one year but not paid until a later taxable year
- Not “qualified” under Internal Revenue Code Section 401(a)
- May or may not be subject to ERISA rules

Overview:

Universe of Nonqualified Deferred Compensation

- Employment Agreements/Severance Arrangements
- Top Hat Plans
- Stock Options
- Restricted Stock
- Stock Appreciation Rights
- Phantom Stock
- Restricted Stock Units
- Long Term Incentive Plans
- Short Term Incentive Plans
- Bonus Arrangements
- May Include Defined Contribution
- May Include Defined Benefit

Matrimonial/Legal Issues: Dividing Marital Property Four Step Process

- Is it property or mere expectancy?
- Is it marital or separate property?
- If marital, should it be valued?
- If marital, how can it be distributed?

Matrimonial/Legal Issues: Analysis

- Is it property or mere expectancy?
 - Callahan v. Callahan, 361 A.2d 561 (1976)
 - NJ Superior Court
 - Stock Options are more than just a right to acquire an asset in the future, they are a form of compensation.
 - If earned during the marriage, subject to equitable distribution

Matrimonial/Legal Issues: Analysis

- Is it property or mere expectancy?
 - DeJesus v. DeJesus, 665 N.Y.S.2d 36 (1997)
 - To what extent is interest in restricted stock and stock options marital property where plans came into being during the marriage but are contingent on continued employment?
 - All are marital property subject to division
 - Depends on whether granted for past or future services

Matrimonial/Legal Issues: Analysis

- Is it property or mere expectancy?
 - IRM Balanson, 25 P.3d 28 (Colo. 2001)
 - Vesting is NOT determinative
 - Stock options are property only when the employee has an enforceable right under terms of the award

Matrimonial/Legal Issues: Analysis

- Is it separate or marital?
 - IRM Balanson, 25 P.3d 28 (Colo. 2001)
 - Stock options granted in consideration for future services, where such services have not yet taken place, are not marital property

Matrimonial/Legal Issues: Analysis

- Is it marital or separate?
 - IRM Short, 890 P.2d 12 (1995)
 - WA community property state
 - Separate property includes earnings while couple living “separate and apart”
 - Microsoft options granted during marriage but vest while parties living separately
 - Application of “time rule” formula

Matrimonial/Legal Issues: Analysis

- What portion is marital?
 - Time rule
 - Pension rule applied to NQDC
 - IRM Hug, 154 Cal.App.3d 780 (1984)
 - IRM Short, 890 P.2d 12 (1995)
 - Coverture fraction
 - Method for apportioning between spouses the benefit of unvested stock options
 - Wendt v. Wendt, 757 A.2d 1225 (2000)

Matrimonial/Legal Issues: Analysis

- How do we value the marital portion?
 - Net Present Value v.
 - Deferred Distribution v.
 - Reserved Jurisdiction

Valuation – Stock Options

- Black-Scholes Model
 - Standard Assumptions:
 - No dividends
 - Exercised upon expiration
 - Market direction cannot be predicted
 - No commissions charged
 - Interest rates remain constant
 - Volatility is constant over time
- Black-Scholes still widely used although assumptions subject to question

Other Valuation Methods – Stock Options

- Binomial method
 - longer dated options with dividends
- “In the money”
 - Simplest solution if options will be divided in kind

Valuation - NQDC

- “If, As and When”
- Present Value –
 - Income taxes (current rate or future rate)
 - Were Social Security and Medicare taxes paid?
 - Value of tax deferral
 - Investment options/performance
 - Timing of payments
 - Risks of default and forfeiture

Matrimonial/Legal Issues: Valuation

- Distribution Impact:
 - Certainty vs. Risk
 - Now vs. Later
 - “True up” Tax considerations – additional fees and complexity

Matrimonial/Legal Issues: Deferred Distribution

- Benefit is divided based on marital fraction
- Distribution occurs when the benefits are actually paid
- Depending on the nature of the benefit, may require that non-employee spouse's benefit be held in constructive trust

Matrimonial/Legal Issues: Reserved Jurisdiction

- Under this approach, the court reserves jurisdiction and the distribution of benefits takes place at the time the employee receives benefits in the future

Matrimonial/Legal Issues: Stock Options

- The marital portion of a stock options grant is determined:
 - First by looking at whether there is an enforceable right (not whether vested or exercisable), and
 - Second by looking at whether options were granted in consideration for services that occurred during the marriage

Matrimonial/Legal Issues: Restricted Stock

- IRM Miller, 915 P.2d 1314 (Colo. 1996)
- Where there was an outright grant of restricted stock during the marriage, and the power to vote and to receive dividends from the stock, the fact that the restrictions would lapse after the date of dissolution did not factor into the court's decision that the property was marital

Matrimonial/Legal Issues: Long Term Incentive Plans

- Retirement Plan Analysis
 - Measure the marital interest using the benefit that will be received upon the assumed normal future retirement
- Balanson analysis
 - Enforceable right v. Mere expectancy

Matrimonial/Legal Issues: Short Term Incentive Plans

- If 100% discretionary, a bonus that is not paid is arguably not marital property
- However, if a discretionary bonus is historically paid, it may be marital
- Also, if ultimately paid, it may be marital to the extent of services performed during the marriage

Matrimonial/Legal Issues: Severance

- Severance may not be deferred compensation if paid after dissolution because it replaces income lost after termination of employment
- Severance may be separate property because the payments substitute for wages which would be the separate property of the dismissed employee. IRM Holmes, 841 P.2d 388 (Colo.App. 1992).
- So, to the extent that termination of employment occurs during marriage, severance is marital – otherwise it is not

Distributions: Determining the Marital Portion

- Time Rule
- Coverture Fraction
- Timing of Services

Distributions: Valuation and Offset

- Trading qualified for nonqualified deferred compensation
 - Risks
 - Tax consequences
 - Acceleration issues

Distributions: Transferring Title to Options

- Transferring title to options from one spouse to the other may trigger adverse tax consequences

Distributions: Transferring Title to Options

- Incentive stock options (ISOs) taxed under Code Sections 421 and 422 - not on exercise, but rather on sale of the stock
- If held for 1 year after exercise then gain taxed as long term capital gain
- Cannot be transferred other than by will/intestate succession or lose ISO status
- Cannot be exercised by other than the grantee or lose ISO status

Distributions: Transferring Title to Options

- When terms of ISO are violated, options become nonqualified stock options (Code Section 422(d))("NSOs")
- NSOs are taxed on exercise
- NSOs are subject to Code Section 409A
- So, if transferring title results in ISO becoming NSO, not only does the tax timing change, but also potentially subject to 20% excise tax, plus interest and penalties, on all amounts deferred under the plan

Distributions: Restricted Stock

- By definition, no way to transfer title while restrictions are in place
- Once restrictions lapse may still be subject to insider trading rules or blackout periods

Distributions: Bonuses and Cash Incentives

- Consider tax withholding issues
- True-up language

Distributions: Constructive Trust

- Many states have approved this method
- Employee spouse holds deferred comp for benefit of nonemployee spouse
- Fiduciary relationship
- Consider “true-up” tax calculation process

Distributions: Limitations on Use of QDRO

- Generally, nonqualified plans are not subject to ERISA and do not use QDROs
- However, nonqualified plans subject to Code Section 409A must use a DRO in order to accelerate payment on dissolution

Deferred Compensation as Income for Support: Previously Distributed Benefits

- The “double dip”
- Avoid by using increase in value from date of division

Deferred Compensation as Income for Support: Existing Benefits

- Ongoing incentive plans
- Annual bonuses
 - Bonus plans v. discretionary bonuses
 - Written v. historical

Deferred Compensation as Income for Support: Severance Non-Competes

- Non-competes may result in significantly reduced income after termination of employment
 - Unlikely to be considered voluntary underemployment

Deferred Compensation As Income for Support: Non-competes

- Non-compete payments are excluded from income calculation in determining child support. IRM Laughlin, 932 P.2d 858 (Colo.App. 1997)

Strategies for Concentrated Stock

- Puts
- Calls
- Collars

QUESTIONS?
