Executive Compensation In Divorce (2021 ed.)

By

Stephen R. Smith

FROMM SMITH & GADOW, PC

Corporate executives make a lot of money. What does "*a lot of money*" mean exactly? The median compensation package for chief executives who run S&P 500 companies soared to $14.5 million in 2021.[1]

Litigating a divorce between a corporate executive and his/her spouse will almost certainly involve complicated issues of income and asset identification, valuation, and division. The critical question for the divorce practitioner representing an executive or his/her spouse is "What should I be looking for?" This article will (1) identify and define several types of qualified and non-qualified components found in corporate executive compensation packages; (2) discuss discovery procedures and tools to identify which of these elements are included in an executive's compensation package; and (3) address strategies for dividing the community portion of such assets and the potential tax implications related thereto.

I. ELEMENTS OF CORPORATE COMPENSATION

Some elements of an executives' compensation are relatively easy to identify and value. Normally, high level executives will have an employment contract that defines the specifics of base salary, performance bonuses (discretionary or nondiscretionary), and other benefits and perquisites such as health insurance, life insurance, and pension/profit-sharing plans. These *pieces of the compensation pie* are relatively simple. But in recent years, these elements have become the smaller slice of the highly compensated executive's overall pay package.

---

[1] Choe, Stan. "CEO Pay Rose 17% in 2021 as profits soared; workers trailed." https://apnews.com, May 27, 2022.

"Over the last decade, the prevalence of base salary, annual bonus, and perquisites as elements of compensation for CEOs has remained fairly constant in both the S&P 500 and the Russell 3000. What keeps increasing, however, is the use of stock awards."[2]

For many corporate executives, the lion's share of their earnings now comes in the form of *equity-based compensation* (stock/options) and nonqualified deferred compensation (deferred stock, deferred investments, cash, or a combination thereof). These nonqualified plans are often referred to as "*Top-Hat plans.*"

Nonqualified vs. Qualified

Nonqualified compensation means compensation that is paid through a plan or agreement which does not meet the qualification requirements under Section 401(a) of the Internal Revenue Code (26 U.S. Code § 401) and which is free from the constraints of the Employee Retirement Income Security Act of 1974 ("ERISA") and similar federal rules and regulations. Nonqualified benefits do not afford the same tax advantages to the corporate entity as qualified plans, like a 401(k). However, nonqualified plans are not constrained by the contribution limits and testing required under the IRC and ERISA, meaning corporations can provide substantially greater financial benefit to a limited number of key employees and executives.

Nonqualified plans are used by business entities for a variety of reasons including, but not necessarily limited to:

- Attracting and retaining senior management;
- As a supplement to pension benefits for highly compensated executives to bypass federal limits;

[2] CEO and Executive Compensation Practices in the Russell 3000 and S&P 500 | 2020 Edition, Hodgson and Tonello (2020). https://www.conference-board.org/ceo-and-executive-compensation-2020

- As a pension supplement to attract key employees who may suffer a reduction in overall retirement plan benefits because of a midcareer or late-career employment change;
- To enhance early retirement programs or "golden parachute plans";
- As a substitute for equity incentive plans in closely held corporations; and
- As a tool for attracting and compensating members of a corporation's board of directors.

The primary reason companies use nonqualified deferred compensation plans is to provide considerable economic benefits to key personnel or highly compensated employees of the company without the limitations created by the IRC. Qualified deferred compensation plans such as 401(k)s must comply with a number of IRC mandated qualifications, including that the "***contributions and benefits***" under such plan may not "***discriminate in favor of highly compensated employees***." Therefore, large companies often utilize nonqualified plans precisely so that they <u>*can discriminate in favor of top-level executives and key personnel*</u>.

<u>Types of *Top Hat* Compensation</u>

A. Deferred Compensation

A deferred compensation arrangement is, in essence, an agreement to delay payment of amounts otherwise owed to an employee until a later date. The employee's objective in such arrangements is to ensure that he/she will be taxed, generally at ordinary income rates, as and when such payments are received. With such a plan, employees may be able effectively to delay taxation and to reduce the rate of such taxation. The corporate objectives in adopting such plans are to offer an incentive to key employees and to ensure deductibility of the compensation payments in the future when they are actually paid.

B. Stock Appreciation Rights (SARs)

A stock appreciation right ("SAR") is a contractual right granted by a corporate employer which entitles the employee to receive, either in cash or in stock of the employer, the appreciation in the value of the employer's stock over a certain period of time. For example, assume Corporation X issues to CEO 1,000 SARs. Each SAR entitles CEO to receive the appreciation in one share of the employer's stock between the issuance date and the exercise date. If the price of Corporation X's stock on the issuance date is $10.00 per share and the price

per share increases to $20.00 on the exercise date, then CEO would be entitled to receive $10,000 ($10 of appreciation times 1,000 SARs). Depending on the SAR agreement, the payment may be made in cash or in shares of corporate stock. Typically, SARs provide that if not exercised by a specific date, they expire.

C. Phantom Stock Plan

The term "phantom stock plan" generally refers to a long-term incentive program which grants employees "units" equivalent to the actual shares of a company's stock. These units are often referred to as "phantom stock." Phantom stock is a contractual agreement between a corporation and its employees that bestows upon the grantee-employee the right *to a cash payment* at a designated time or in association with a designated event in the future, which payment is to be in an amount tied to the market value of an equivalent number of shares of the corporation's stock. As with any incentive based compensation, the amount of the payout will increase as the stock price rises, and decrease if the stock price falls, but without the grantee actually receiving any stock. Phantom stock plans are non-qualified compensation arrangements and do not involve the actual issuance of stock or securities by the company. These plans allow key executives, employees, or directors to participate in the growth of a company, without adding actual additional shareholders.

D. Restricted Stock Plans

Restricted stock means just that - stock which is awarded to an employee under various types of “vesting” restrictions and conditions. Under a restricted stock plan, a corporation (usually through its Board of Directors) determines to whom restricted stock is to be issued. The stock restrictions are conditioned on the employee's continued service to the company over a specific number of years (or other criteria, such as meeting performance objectives). A portion of the employee's shares become unrestricted stock owned by the employee at the completion of each year of service (known as *periodic vesting*) or, in some cases, all the shares become unrestricted at the end of a single, specified period (known as *cliff vesting*).

E. Incentive Stock Options

A stock option is simply the right granted to an employee to purchase a certain number of shares of the corporation's stock at a pre-established price (the "*Strike Price*.") *Incentive stock options* (ISOs) are stock options issued by a corporate employer which meet the requirements of §422 of the IRC. (A discussion of those requirements is beyond the scope of this article.) Generally, stock options are granted to employees at a price which is greater than the market price of the corporate stock on the date of the grant. Said option therefore creates the "incentive" for the employee to work hard and improve the market value of the company, thus raising the value of the stock option.

F. Non-Qualified Stock Options

Options that do not meet the requirements of an ISO under IRC § 422, are called nonqualified stock options (NQSO). Nonqualified stock options do not enjoy the same favorable tax treatment that incentive stock options do. NQSOs tax treatment is governed by IRC §83. Under the code, the tax consequences to the employee and the corporation depend on a determination of when the option has a "readily ascertainable" fair market value. Under the Regulations, the option has a readily ascertainable fair market value at the time it is granted only if traded on an exchange. In those cases where the option has a "readily ascertainable value, the option holder realizes income either (1) when his right in the option becomes transferable or (2) when his right in the option is not subject to a substantial risk of forfeiture. In essence, the difference between and ISO and an NQSO is that an ISO only triggers a taxable event when it is exercised, whereas an unexercised NQSO could still create a taxable event if it is "transferable" (i.e., vested and/or unrestricted) and is not subject to forfeiture or loss.

II. Identifying the Elements of the Executive's Compensation: The Discovery Process

Federal securities laws require that publicly traded companies issue clear, concise, and understandable disclosure about compensation paid to CEOs, CFOs, and certain other high-ranking executive officers. Several types of documents that a corporation files with the SEC are public record and contain information about the company's executive compensation policies and

practices. For example, you can locate information about the very top level executives' pay in corporate SEC filings like:

(1) The company's annual proxy statement;

(2) The company's annual report on Form 10-K; and

(3) Registration statements filed by the company to register securities for sale to the public.

Proxy statements are a great starting point for information regarding the executive divorce litigant. In the annual proxy statement, a company must disclose information concerning the amount and type of compensation paid to its chief executive officer, chief financial officer, and no fewer than the three other most highly compensated executive officers. A company also must disclose the criteria used in reaching executive compensation decisions and the relationship between the company's executive compensation practices and corporate performance. [3] Proxy statements must capture every form of compensation paid to the executives including cash salary and bonuses, stock or other equity awards, non-equity incentive compensation, and the value of any other forms of compensatory benefit.

But what if the executive does not work for a publicly traded company or is not one of the five highest paid executives? Just because a company isn't publicly held doesn't mean that it can't be very large. Each year, Forbes magazine publishes a list of the largest private companies in the world. The 2020 list includes Fidelity Investments ($21B in annual revenue), SC Johnson ($10.5B), and Koch Industries ($115B), the largest privately held company in the U.S. Privately held companies often utilize nonqualified deferred compensation tools to compensate their highly paid executives. Because these companies are privately held, they are not necessarily required to publish the same types of information that publicly traded companies must. When dealing with private companies, the best source of information is going to be the company itself.

Whether the company is publicly traded or privately held, a well drafted subpoena to the corporate entity is likely to be the best method for obtaining detailed information regarding the compensation package. Under the Arizona Rules of Family Law Procedure, the executive

---

[3] http://www.sec.gov/answers/execomp.htm

spouse is, of course, obligated to disclose any and all information and details regarding his employment compensation and benefits. But relying solely on the disclosure from an opposing party can be a hazardous proposition. From a "best practices" standpoint, it is wise to issue a subpoena to the opposing party's employer even when he/she is willing to provide complete disclosure. The role of a divorce attorney is to *trust but verify* the information provided by the opposing party. Issuing a well drafted subpoena to the other party's employer is simply a step in the *trust-but-verify* process.

III. Division Strategies and Tax Traps

Once you have identified the scope of the executive spouse's compensation benefits, you must then address how to appropriately divide or allocate them in the context of the divorce. In a marriage where one or both of the spouses are highly compensated individuals, the marital community usually has amassed a sizable estate consisting of readily ascertainable liquid assets (cash, publicly traded securities, etc.), and illiquid assets (real estate, private equity investments/holdings, etc.) which can be used to offset employment benefits held in the name of the employee spouse.

For example, assume that the executive spouse has a compensation package which includes $3M in restricted stock, options, and deferred compensation. Also assume that the parties personally hold $10M of other assets, which include multiple homes, a stock portfolio, and interests in closely held LLC's. In such a situation, the employment assets can be assigned to the executive spouse with a like assignment of $3 million of comparable assets to the nonemployee spouse, with the remainder of the community estate divided between the parties. Of course, detailed analysis is required to ensure that you are trading apples for apples (considering tax implications and the like), but with publicly traded or long-established companies which are unlikely to have substantial short-term gains or losses in their stock value, such an arrangement is likely feasible and can be accomplished in an equitable manner.

But what if the executive spouse works for a startup company in which he has been awarded substantial stock, options, or other equity benefits that have substantial potential upside. In this situation, it may be more beneficial to the nonemployee spouse to receive her actual share in such equity assets rather than receive other offsetting assets. Equity positions in rapid growth or startup companies can often be like a lottery ticket - the shares could end up being worth a substantial sum, or they could end up being worth nothing. Awarding such equity

assets to the employee spouse with an offset to the other could be remarkably unfair to the employee spouse (if the company tanks) or remarkably unfair to the nonemployee spouse (if the company ends up being the next Amazon, Google, or Tesla.) In these situations, the best result for the nonemployee spouse may be to actually receive a share of the options or stock, or at least receive the beneficial interest in the options or stock. Methods for such division are discussed below.

Tax Treatment of Incentive Compensation

Internal Revenue Code § 1041 generally provides that divorce-related transfers of property are tax-free and that the transferee spouse takes such property with a carryover basis from the transferor spouse. It applies to nearly all kinds of property commonly transferred in a divorce, such as houses, cars, investments, etc. Revenue Ruling 2002-22 provides that, if *vested options* are transferred in connection with a divorce, the transfer constitutes a transfer of property under Section 1041. The transfer of vested or unrestricted stock also falls under the umbrella of section 1041. Thus, transferring vested options or stock is not a taxable event, so the transferee spouse receives the stock/options at the same basis as the employee spouse held them (which in the event of an un-exercised incentive stock option is a zero basis). When the transferee spouse exercises the option, he/she realizes income equal to the spread between the option strike price and exercise price. In other words, from a tax perspective, the nonemployee spouse who receives a vested option or a share of unrestricted stock simply steps into the employee spouse's shoes. For reporting and withholding purposes, the employer reports the income upon exercise by the non-employee spouse on a 1099-MISC and makes supplemental withholding at the appropriate rate.

Often, employees will exercise options and then immediately sell the underlying stock. This is frequently a cash free transaction whereby the employee "borrows" the strike price from the employer and then repays the borrowed funds out of the sales proceeds from the sale of the underlying stock. If the corporate option agreement allows for transfers of options to a non-employee former spouse, said transferee spouse can likewise execute a cashless exercise of the options. The end result is that the transferee/nonemployee spouse receives a check equal to the spread between the value of the stock and strike price reduced by supplemental

withholding (at the appropriate flat rate), as well as a reduction for employment tax withholding (which is generally calculated on the transferor/employee's wages).

For example, assume that employee X gets divorced and at the time, holds an option to buy 100 shares of Employer's stock for $50 a share. Assume also that the corporate stock plan allows the transfer of the options to a nonemployee spouse. Nonemployee spouse elects, one year later, to exercise her 50 shares at a sale price of $100. The cashless transaction results in a gross benefit to the nonemployee spouse of $2,500. (50 shares X the $50 spread between the strike price of $50 and the sale price of $100.) The Corporation issues a check to the nonemployee spouse, after appropriate withholdings.

While the *income tax burden* should always be borne by the transferee/non-employee spouse on her exercise of options, potential complications arise from the *employment tax burden* for such options. Normally, that tax is calculated by reference to the *employee spouse's W-2 wages*. Well drafted marital settlement agreements should make clear that, despite this problem, the transferee/nonemployee spouse bears the burden *of all taxes* resulting from exercise of an option.

Unvested Benefits

While Revenue Ruling 2002-22 clarified the treatment of *vested* options, it explicitly exempted unvested rights. Therefore, it does not apply to transfers of nonstatutory stock options and other nonqualified compensation such as unfunded deferred comp rights or other future income rights (SARs, RSUs, Phantom Stock, etc.) Any employment benefits that are unvested at the time of transfer or to which the transferor's rights are subject to substantial contingencies at the time of the transfer do not necessarily get the benefit of section 1041 protection. *See, e.g., Kochansky v.Commissioner*, 92 F.3d 957 (9th Cir. 1996).

This carve-out applies to unvested stock options (which are specifically mentioned in RR2002-22), and also to restricted stock because these "future income rights" are unvested at the time of transfer. This suggests that if unvested rights or nonqualified benefits are transferred in connection with a divorce, the transferor/employee spouse could remain liable for the tax upon the subsequent taxable event. For example, in *Kochansky*, a personal injury lawyer transferred half of an unmatured contingent fee to his spouse who later collected half of the fee when the case was settled. An issue arose as to whether WIFE was responsible for the taxes on her

gross portion of the fee that she received. The Ninth Circuit held that the lawyer, not his transferee spouse, was liable for the tax on the transferee spouse's share. Care must be taken in crafting settlement documents to make sure the parties are acknowledging the potential tax implications. Language should always be included that requires indemnification of the employee spouse by the non-employee spouse in the event the taxing authority disavows the spouses' agreed-upon tax arrangement.

Further confusing the "vested v. unvested issue, a 2010 IRS private letter ruling (2010-16-031), held that restricted stock transferred pursuant to a divorce was taxable to the transferee spouse "upon vesting."[4] This appears totally inconsistent with *Kochansky*. The private letter ruling addresses Revenue Ruling 2002-22 but does not mention the ruling's carve-out for unvested rights. The Private Letter Ruling's conclusion was the result desired by the parties, and the divorce decree explicitly provided that (i) the parties intended "a result consistent with RR2002-22" and (ii) the transferee spouse was "responsible for paying all costs attributable to [the transferee's] allocation of restricted stock, including taxes other than [employment] taxes." The Private Letter Ruling seems to imply the RR2002-22 approach will apply all equity compensation items transferred in connection with a divorce whether vested or not. However, private letter rulings ***do not constitute binding precedent on the IRS*** except with regard to the particular taxpayers to whom they are issued.

Division/Allocation

There exists a lack of clarity regarding how the IRS will treat allocation of vested equity benefits as opposed to nonqualified and unvested equity benefits. So how does the careful practitioner best handle this problem? The safest, most obvious approach would be to avoid transferring unvested and non-qualified assets altogether. If an equitable distribution can be accomplished by transferring only non-compensation items and vested assets, then the risk is avoided. Delaying the entry of the divorce settlement for a short period of time to allow pending benefits to vest could be beneficial in some cases.

You could seek a private letter ruling from the IRS, such as the one mentioned above. This will likely involve additional time and cost, but if the stakes are significant enough, it is likely

[4] IRS Private Letter Rulings are available to the public at: http://apps.irs.gov/app/picklist/list/writtenDeterminations.html

well worth the trouble. If large amounts of unvested items need to be transferred and delay is not a significant concern, the private letter ruling should be considered.

If unvested and nonqualified compensation assets must be transferred and a private letter ruling request is not feasible, the most conservative approach would be for the parties to agree that the transferor spouse will report the income and employment tax resulting from the future taxable event, but that the transferee spouse will bear the economic burden of the tax. To implement this structure, the parties would use a constructive trust whereby the employee spouse retains legal title to the unvested items for the benefit of the nonemployee spouse. This option may be the only option available with certain companies that absolutely prohibit any transfer of unvested benefits to a former spouse.

In the case of stock options, the employee spouse would agree to exercise the options and sell the underlying stock at the direction of the non-employee spouse and then pay the after-tax proceeds to him/her. This approach has a number of attractive features. First, the tax treatment is most consistent with Revenue Ruling 2002-22's explicit carve-out of unvested assets. Second, as mentioned above, some employers preclude or discourage employees from transferring unvested compensation items in divorce making a constructive trust a necessity. Finally, because legal title to the items remains in the hands of its employee and the eventual tax consequences are reported on the employee's W-2, the employer's procedures for tax reporting are unaffected.

Constructive trust arrangements should always include some technical provisions to ensure that the parties receive the results that they expect. As mentioned above, the spouses must agree to indemnify one another in the event the IRS disallows the planned tax treatment anticipated by the parties' settlement. This will ensure neither spouse is double taxed on the item and no one receives a windfall.

Second, to calculate the after-tax payments that go to the transferee spouse upon vesting or exercise, *the transferor's effective marginal tax rate* needs to be determined. Since the rate will be known with accuracy only after the end of a taxable year and because withholding rates may differ from a taxpayer's ultimate marginal tax rate, a stipulated or assumed rate can be used. For high-income wage earners, the highest effective marginal federal income and employment tax rate exceeds 40% (37% Federal, plus 1.45% Medicare, and anywhere from 2.59% to 4.5% Arizona state tax). There are two advantages to using a stipulated or assumed

tax rate instead of determining the actual tax rate on an *ex-post facto* basis. First, it gives both parties clarity as to the amount of taxes to be withheld upon each transfer of money from the transferor spouse to the transferee spouse. Second, using a stipulated rate avoids the need for the transferor spouse to periodically share his or her post-dissolution tax returns with the former spouse for the purpose of determining the actual effective marginal tax rate. In the event that a stipulated tax rate cannot be negotiated, then the parties can agree to exchange tax documents and to make true up payments after the end of the year once the actual marginal tax rate is calculated.

CONCLUSION

Great care must be taken when representing highly compensated corporate executives or their spouses in a marital dissolution matters. The complexities of equity and incentive compensation, as well various potential forms of non-qualified benefits and deferred compensation, create a vast minefield of potential tricks and traps that must be understood and navigated. Moreover, potential concerns regarding tax treatment of unvested or deferred benefits must be carefully analyzed and addressed.