The Not So Easy to Identify Executive Employee Deferred Compensation Plans and Relevant Issues in Their Identification, Taxation, Valuation and Characterization

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"Direct and Cross-examination of an Expert on Attorney's Fees", Texas Academy of Family Law Specialists - 1991
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"Valuation of Partnerships", State Bar of Texas Advanced Family Law Course - 1992
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"Post Judgment Motions and Requests in Family Law Litigation from Rendition of Judgment to Perfection of Appeal",
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"Advanced Trial Tactic", State Bar of Texas, Advanced Family Law Course - 1996
"Practical Tips for Characterization, Tracing and Reimbursement”, State Bar of Texas, Marriage Dissolution Course - 1997
“Resolve that the legislature should find the ‘reasonable needs of a child’ or limit the amount of child support to be paid”, Advanced Family Law Course - 1997
“Handling A Divorce Involving A Closely-Held Corporation (Valuation, Alter Ego, Jensen, And Other Claims)” State Bar of Texas, Marriage Dissolution - 1998
“Evaluation of Closely-Held Businesses”, American Academy of Matrimonial Lawyers - 1998
“Family Law for Fun and Profit: Practical Tips for Avoiding Pitfalls and Enjoying Success, Solvency, and Sanity
In The Practice Of Family Law”, State Bar of Texas, Advanced Family Law Course - 1998
“Strategies for division of the complex estate”, New Frontiers - 1998
“Mediation – Be Prepared”, State Bar of Texas, Marriage Dissolution - 1999
“Law Office Economic,” published by State Bar of Texas, Advanced Family Law Course, 1999
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TABLE OF CONTENTS

I. INTRODUCTION 1

II. PROPERTY TRANSFERS-§1041/ASSIGNMENT OF INCOME DOCTRINE 1

III. IDENTIFICATION OF NON-QUALIFIED PLANS AND THEIR CHARACTERISTICS 2
- A. Income Tax Treatment and Differences 2
- B. Example Illustrating the Importance of "Conquering before Dividing" 3

IV. IMPACT OF ERISA ON NON QUALIFIED PLANS. 5

V. VALUATION & CHARACTERIZATION ISSUES 7

VI. DISCUSSION OF TAX ISSUES RELATED TO THE DIVISION OF NONQUALIFIED PLANS. 10
- A. Review of Stock Option Issues 10

VII. USE OF EXPERTS; RESOURCES 13
- A. Use of Experts 13
- B. Sources of Information 13

ACKNOWLEDGMENTS 13

APPENDICIES

The Not So Easy to Identify Executive Employee Deferred Compensation Plans and Relevant Issues in Their Identification, Taxation, Valuation and Characterization

I. INTRODUCTION

One of the more challenging aspects of a divorce is dealing with the issues presented by the various types of "non-qualified" deferred compensation arrangements that may be components of a marital estate. These property rights can often be difficult to identify, value, and divide since they take many forms and are subject to varying degrees and levels of regulation. For example, these plans might be subject to the provisions of ERISA[1] in terms of their operation, the Internal Revenue Code in terms of taxation and reporting of payments from the plan, the governing plan document in terms of administration and State marital property statutes and case law in terms of valuation and division. Therefore, the practitioner may have to operate within the constraints of all applicable governance relating to these plans when attempting to effect their division.

The battles over the value inherent in nonqualified deferred compensation plans are almost always hard-fought[2], and the only way to develop a true "working awareness" about the issues related to these plans is to tackle a case or two where a nonqualified deferred compensation plan is one of the principal assets of the marital estate being divided.

II. PROPERTY TRANSFERS -§1041 ASSIGNMENT OF INCOME DOCTRINE

In order to provide a context for the some of the issues discussed in this paper, a brief discussion of one of the cornerstones of divorce taxation should be presented-Internal Revenue Code (IRC) §1041.

The tax consequences of property transfers incident to a divorce are governed by §1041, which holds that transfers of property between spouses incident to divorce are generally nontaxable and are treated as value for equal value exchange between the transferor spouse to the transferee spouse. This means that for tax purposes, the adjusted basis of the property in the hands of the transferor carries over to the transferee.

To qualify under §1041, the transfer must be to a spouse, or a former spouse, but a transfer to a former spouse only qualifies if the transfer is incident to the divorce.[3]

A transfer is considered to have been made "incident to divorce" for purposes of this section if the transfer occurs within one year after the date on which the marriage ceases, or is related to the cessation of the marriage.[4] Any transfers made after one year but within six years are considered made incident to divorce only if specified in the divorce decree and transfers made after six years are not considered to be incident to divorce.[5]

The general rule of non-taxability will not apply if the transferee spouse is a non-resident alien.[6]

Additionally, if the property being transferred is encumbered with a liability in excess of its tax basis, the transferor shall recognize gain to the extent of the excess, and such gain recognition will be added to the transferee's basis.[7] However, this only applies if the property is transferred to a trust for the benefit of the transferee spouse, and the test is not met unless the liability exceeds the basis on not only one particular property, but on all properties being transferred.

The general non-recognition rules apply to all types of property: real, personal, intangible or tangible. They also apply to indebtedness that is discharged in the transfer.[8]

Now that the provisions of Section 1041 have been outlined, the tax doctrine providing for a prohibition against the "assignment of income" should be reviewed. This doctrine is a pervasive tax concept that is also central to the understanding of the tax issues attendant to the division of nonqualified deferred compensation plans. This concept provides that the incidence of taxation of income falls upon the person or entity that earned it. In other words, income cannot be beneficially assigned to another party in order to reduce or minimize its tax burden. For example, a taxpayer could not, by contract, assign half of his wages to his wife, thus taking advantage of the progressive tax tables twice. Simply put, the assignment of income doctrine holds that income must be taxed to the person who earns it. The most overused metaphor in taxation arises from this doctrine - that of the "fruit and the tree".[9] This metaphor states that the person who owns the tree may gratuitously assign his right to pick the fruit, but for tax purposes, he remains

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[1] Employees Retirement Income Security Act of 1974, codified as 29 U.S.C §§ 1001-et. seq.

[2] Due to the significant benefits that often flow from these plans and the participant spouse's perception that the benefits came only from his personal efforts-and are somewhat of a "sacred cow."

[3] IRC § 1041(a)

[4] IRC § 1041(c)1-2

[5] Treas. Reg. Sec. 1.1041-1T(a) Q&A6-7

[6] IRC § 1041(d)

[7] IRC § 1041(e)

[8] Treas. Reg. Sec. 1041-1T(a) Q&A 4

[9] *Lucas v. Earl,* 281 US 11 (1930)

liable for the income tax on it. The IRS has also taken the position that an assignment of an interest in a "nonqualified plan" is an assignment of income[10] and has vigorously defended the "assignment of income doctrine" against transactions that it perceives as transfers of the right to receive income. It views these transactions as prohibited "assignments of income" and in the divorce context, argues that § 1041 applies to non-recognition of "gain" as opposed to "income".

However, the tax court has set aside the IRS' attempt to characterize divorce-related transfers as prohibited assignments of income in the context of the awarding of a portion of military retirement pay[11] and, a share of lottery winnings.[12] In a private letter ruling (PLR), the IRS ruled that transferee ex-spouse would not be taxed on the net proceeds of a contingent settlement of transferor spouse's lawsuit for patent infringement because she is only being granted a share in the monetary reward for the lawsuit, not an interest in the patent itself, which would be considered income producing property.[13] However, in other PLR's, the IRS ruled that the participant spouse interest in a nonqualified deferred compensation plan in a community property state would only be taxable on his portion of the income awarded from the plan.[14] In an earlier PLR, the IRS held that the non-participant spouse/alternate payee in a common-law state would have to pay tax at her ex-husband's higher rate on distributions from a non-qualified deferred compensation plan.[15]

Thus, in the context of nonqualified deferred compensation plans, the most important tax question in the divorce context is often whether or not a particular bundle of rights is an asset, and transferable free of tax consequence under §1041 or is merely income that may not be assigned from the participant spouse to the non-participant spouse. As seen above, this determination may be driven by state marital property laws. For example, is the right to receive income, such as a vested benefit in a nonqualified defined benefit pension plan, an asset in and of itself or is it just an income stream with no underlying asset? The provisions of ERISA appear to establish such property rights as assets. However, until recently, the IRS has taken the position that vested benefits in nonqualified deferred compensation plans constitute non-assignable income that cannot be transferred tax-free under §1041. Although the IRS has issued recent guidance with respect to this issue that clears up some of the uncertainty, a state of tension still exists between IRC §1041 and the "assignment of income" doctrine.

III. IDENTIFICATION OF NON-QUALIFIED PLANS AND THEIR CHARACTERISTICS

A. Income Tax Treatment and Differences

The terminology "qualified" and "nonqualified" essentially refers to the treatment of the plan with respect to the Internal Revenue Code, which is the codification of ERISA within the public law. When an employer makes a contribution to a qualified plan, the effect is generally a current tax deduction for the employer and no current tax impact with respect to the benefited individual or class of individuals. Taxation of the benefit typically does not occur until it is withdrawn from the plan in cash, thus forcing the federal government to subsidize the contribution "up front." This tax asymmetry comes at a price for employers and employees-compliance with stringent rules regarding the design, operation, and administration of qualified plans, as well as fiduciary liability imposed on plan administrators for mismanagement of qualified plan assets.

In contrast, a benefit accrual for or contribution to a non-qualified plan generally does not involve either a current tax deduction for the employer or current taxation to the employee. This result is achieved only if the current value used (or foregone by the employee) to provide the *future* benefits to be derived from the plan were never in the hands of the employee *before* they were placed in the vehicle for the funding of the benefit, if participation in the plan is elective or funded by the employee.[16]

For example, if participation in a nonqualified defined contribution plan is elective on the part of the employee, the compensation that is going to be deferred into the plan cannot pass through the employee's hands prior to being placed in the plan. In other words, the employee cannot "turn his back on

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[10] Whether or not incident to divorce. This may not be an issue if the value of the interest in the plan is a community asset. The income realized upon liquidation of the plan balance to cash out a non-participant spouse would be community and therefore taxed to both spouses. The author has had many spirited discussions about this issue with other practitioners in the context of a community property state (e.g. California and Texas), but until the issuance of Revenue Ruling 2002-22, discussed below, the "safe" route in a divorce decree was perceived to be taxing nonqualified deferred comp distributions to the non-participant spouse at the participant spouse's tax rate.

[11] *Balding v. Comm.*, 98 TC 368 (1992)

[12] *Smith v. IRS,* 75 AFTR 2d 95-2253 (1994 DC NY)

[13] PLR 9143050 (PLR's cannot be used or cited as precedent by parties other than the taxpayer who requested the ruling, but they can demonstrate the IRS' frame of mind with respect to various issues)

[14] PLR's 9647033, 8751029, 8451031

[15] PLR 9340032

[16] Yet another application of the "assignment of income doctrine."

income" that was made available to him in the form of current value. The employee must elect to participate in the plan before the income is earned.

However, additions of value (in the form of a contribution or accrual, as the case may be) to a non-qualified plan fall within the definition of income subject to *employment* tax, while such additions made by an employer to a *qualified* plan do not.[17] This means that participants in a non-qualified deferred compensation plan may have to pay FICA and Medicare taxes on additions to their plan balances or vested benefits or when benefits are cashed out (i.e. stock option exercises).

Another key difference between qualified and non-qualified plans involves issues related to plan funding. Qualified plans are funded by the employer and/or employee, generally, in the form of a set-aside of assets or into a "qualified trust" that is exempt from the claims of creditors and separate from the assets of the employer. The earnings of this trust are reinvested within the trust free of current income tax to provide a component of the future retirement benefit.

Nonqualified plans, on the other hand, may consist only of a promise to pay a specified amount upon the retirement of the employee or other event, and are nothing more than an unfunded, unsecured promise to pay at a future date. If funds *are* actually set aside to provide for future payment of benefits from a nonqualified plan, however, they must be held in a certain form in order for the participants in the plan to not incur current income taxation upon the funding of the plan[18] and for the plan to retain its unfunded status. The vehicle of choice to hold plan assets in this situation is the "rabbi trust." A rabbi trust is a vehicle in which assets are segregated from the general assets of the employer but are still available to its creditors in the event of bankruptcy or insolvency. The earnings of the trust are taxed to the employer. Nonqualified deferred compensation plans can be funded with a "secular" trust, one that is beyond the reach of the company's creditors, but funding results in current income to the participant and a deduction for the employer. Additionally, trust earnings are taxed to the plan participants, not the employer. Finally, an employer may attempt to use a "springing rabbi trust", for one that starts out as a rabbi trust, but at the first signs of financial danger, is converted to a secular trust, an event which would cause current taxation to the plan participants and could cause additional levels of regulation under ERISA. For example, we all witnessed the conversion of the rabbi trust holding American Airlines' executive nonqualified deferred compensation plan assets to a secular trust in early 2003, at the same time company executives were asking unions to accept significant pay concessions. The use of this type of device may be limited by new tax code provisions discussed below.

Another extremely important difference between the tax aspects of qualified and nonqualified plans is the amount of benefit that can be set aside or accrued for participants during the "accumulation" period and the amount and form of benefit payments.

An entire volume could be written on the various limitations on additions to and withdrawals from qualified plans. The reader is referred to the charts in Appendix A for a brief comparison of the various limitations on contributions to and other aspects of qualified plans. The information in this Appendix is subject to change on a yearly basis, but is a useful reference in comparing various qualified plans and understanding the limitations thereon. Plans that provide contributions and additions to benefits that are in excess of these levels (hopefully by design and not inadvertently) will definitely be non-qualified in nature. Generally, qualified plans can consider compensation up to a certain amount and the amount "set aside" for a participant (in a defined contribution plan) is limited to the lesser of participant's compensation or a set amount.

Nonqualified plans generally have no such limitations imposed upon them by the Internal Revenue Code. For example, the author observed a non-qualified defined benefit plan in operation that (intentionally) exceeded the two key limitations on the accrual and payment of benefits from qualified defined benefit plans. The first limitation exceeded was that contained in IRC §401(a) (17). That section limits the amount of compensation that can be considered when making benefit accruals for the benefit of the participant. This amount changes yearly. The following table presents the current and prior annual limits:

Year	Limit
2006	$220,000
2005	$210,000
2004	$205,000
2003	$200,000
2002	$200,000
2001	$170,000
2000	$170,000
1999	$160,000

To reiterate, a qualified defined benefit plan cannot consider an employee's compensation over and above the limitations in the table above. Any defined benefit accrued on compensation in excess of the §401(a)(17) limitation would have to be "contained" in a *non-qualified* defined benefit plan. An executive's annual

[17] IRC Section 3121

[18] Avoids application of the "constructive receipt" doctrine with respect to the employee.

compensation can therefore provide clues as to when the executive began to participate in such a non-qualified plan.

Conversely, a qualified defined benefit plan cannot provide a yearly *benefit* in excess of certain amounts. This limitation is contained in IRC §415(b)(1) as the lesser of 1) 100% of the participant's average three highest year's compensation or 2) $160,000. The limitation is adjusted downward to the actuarial equivalent for employees who commence the receipt of their benefit before age 62 and adjusted upward to the actuarial equivalent for employees who commence the receipt of their benefit after age 65. Therefore, benefits paid in excess of the §415(b) limitation cannot come from a qualified plan. Rather, they would be paid from a non-qualified plan that most likely considered compensation in excess of the §401(a)(17) limit.

On October 22, 2004, President Bush signed into law HR 4520, the American Jobs Creation Act of 2004 (PL 108-357). This Act provides a new Internal Revenue Code section pertaining to non-qualified deferred compensation plan-Section 409A. Additionally, the Act clarified that compensation resulting from the exercise and disposition of stock from an Incentive Stock Option or Employee Stock Purchase plan is NOT subject to mandatory federal income tax withholding and is NOT subject to FICA and FUTA taxes.

Code Section 409A provides specific guidance as to whether deferral of income inclusion will be permitted under non-qualified deferred compensation arrangements. Generally, under new statutory rules, arrangements that allow plan participants inappropriate levels of control or access to deferred amounts will not result in deferral of income. Specifically, if compensation deferred under these types of plans for the current and preceding tax years will be includable in gross income (with a 20% penalty tax and interest calculated from the date of deferral!) to the extent the participant's share of the plan is not subject to a "substantial risk for forfeiture and was not previously included in gross income if the plan fails to meet the all of the statutory requirements for distributions, acceleration of benefits, and elections. For example, recall the discussion of the conversion of the "rabbi trust" to a "secular trust" for the benefit of American Airlines Executives. This event would have caused full taxation of the plan benefits to the executives under IRC 409A, plus the applicable penalty tax and interest.

Under Section 409A, distributions from non-qualified deferred compensation plans cannot take place before the earlier of:

1. Separation from service;
2. Disability of participant;
3. Specified Time according to a fixed schedule that existed at the time of the deferral of the compensation;
4. A change in ownership or control of the company or the ownership of a substantial portion of the assets of the corporation (to the extent permitted by regulations);
5. the occurrence of an unforeseeable emergency

A full discussion of the 409A rules is beyond the scope of this paper, but family lawyers should not be surprised when they are reviewing the terms of nonqualified deferred compensation plans that are assets in a marital estate and note recent substantial revisions to their terms in order to comply with the provisions of the new law. As an aside, it should be noted that the PGA Tour Inc. scored an "eagle" with respect to Section 409A, as non-qualified executive deferred compensation plans maintained by that organization are *exempt* from this provision!

B. Example Illustrating the Importance of "Conquering before Dividing"

Consider these facts. An executive's annual compensation was in excess of $1 million, and it was all considered in making the accrual in a defined benefit plan for the participant, resulting in a monthly-accrued vested benefit of $20K at age 62. In order for the plan to be qualified, only compensation up to the 401(a)(17) limit could have been considered, resulting in a much lower accrued benefit. Additionally, the $240K annual benefit violated another restriction, that of IRC Section 415. This provision limits the yearly benefit that can be *paid* to a participant in a defined benefit plan (currently $165,000 per year for participants who separated from service on or after January 1, 2004).[19].

In that particular case, the $20K monthly benefit was provided by what is known as an "excess benefit plan."[20] The executive attempted to portray this *non-*

[19] For participants who separated from service prior to January 1, 2004, the limitation for defined benefit plans under Code Section 415(b)(1) is computed by multiplying the participant's compensation limitation as adjusted through 2003 ($160,000) by 1.022.

[20] The purpose of such plans is generally to replace in the form of defined contribution or defined benefit. The author has a tax client who participates in a "BRP", or Benefits Restoration Plan. The client is limited on how much he can defer in his 401(k) how much employer match can be received. Amounts less than the "but-for" maximums are credited to his "account" in the non-qualified defined contribution plan in the form of phantom stock.

qualified plan, that had a separate plan document[21] and whose assets were held separately in a rabbi trust, as a *component* of his employer's *qualified* plan.[22] This would have been advantageous to the participant in the division of the marital estate. The marriage that was ending had started about halfway through the executive's longtime employment with the company. If the non-qualified plan had been considered a *component* of the qualified plan, about 50% of the benefits from the non-qualified plan and the qualified plan would have been community, utilizing an allocation formula. However, the executive could not have become a participant in the non-qualified plan until his annual earnings surpassed the §401(a) (17) limitation, and this did not happen until *after* the date of the marriage. Bringing this somewhat obscure provision of the IRC to the attention of the court assisted in the finding that the non-qualified plan was not a component of the qualified plan, but rather a separate and distinct non-qualified plan and the character of the non-qualified plan (separate vs. community) was 100% community as opposed to the 50% community balance of the qualified plan. This resulted in the increase of the community to be divided by more than $5,000,000.00 of which Wife was awarded sixty percent (60%).

It must be mentioned that the payments from excess benefit plans are often based on the same benefit formula as the qualified plan, as was the case in the situation discussed above. The benefit may be structured based on the amount of benefit that was "lost" due to §401(a) (17) or §415 limitation, which provides an argument that the non-qualified plan "piggybacks" on the qualified plan, or is a "component" or "restores" (hence the terms "Restoration Plan") of the qualified plan. The plan design presented in Examples 7 and 8 of Appendix B may provide more argument for the proposition that the non-qualified plan is a "component" of an "overall" plan, but my involvement in the case did not allow for a detailed analysis in this regard.

IV. IMPACT OF ERISA ON NON-QUALIFIED PLANS.

As most readers of this paper are aware, the Employer's Retirement Income Security Act of 1974 (ERISA) is the principal governance for qualified employee benefit plans. In order to keep this paper brief, the reader is directed to Brenda Keen's analysis of executive compensation that is cited below[23], for a detailed analysis of ERISA's applicability to employee benefit plans and nonqualified deferred compensation plans, as well as Professor Weidenbeck's informative article which may be found at http://www.wulaw.wustl.edu/WULQ/76-1/761-21.html.

ERISA provides the rules and regulations for the design, administration, and operation of qualified employee benefit plans and dealings by and between the plan, the employer, the plan administrator, the participants, and other individuals and entities having dealings with the plan. ERISA is a federal statute that broadly pre-empts State laws regarding employee benefit plans. ERISA applies to both qualified and non-qualified plans, albeit to varying degrees. As Professor Weidenbeck states in his article at page 16, "ERISA's principal effect on unfunded deferred compensation arrangements is to provide a mechanism for federal judicial enforcement of the terms of the plan which (as a result of the ouster of state law) must be interpreted and applied according to federal common law." Essentially only the reporting and disclosure rules, the enforcement mechanism, and preemption apply to unfunded deferred compensation plans. Provisions relating to participation, vesting, fiduciary responsibilities, form of benefit and the prohibition against alienation generally do not apply to these sorts of plans.

For example, ERISA requires that with respect to plans subject to its provisions, participants may not be divested (alienated) from his or her benefits, as codified in IRC §401(a) (13). However, in 1984, IRC §414(p) and §401(a)(13)(B) were enacted to resolve uncertainties as to whether a participant's interest in a pension plan was assignable to satisfy family support obligations without casting doubt on the plan's qualified status. Under §414(p), a document known as a "qualified domestic relations order" (QDRO) is utilized to effect a transfer of qualified plan assets to the non-participant spouse.

§414(p) specifies all of the requirements for a valid QDRO. Specifically, §414(p)(1)(A) defines the QDRO as a document that creates or recognizes the existence of an alternate payee's right to, or assigns to an alternate payee the right to, receive all or a portion of the benefits payable with respect to a participant under a plan. To be a valid QDRO, the document must:

- Be pursuant to a "domestic relations order" (see §414(p) (1) (B)),
- Specify certain facts (see §414(p) (2)),

[21] Received by the wife's attorney very close to the trial date!

[22] The qualified plan paid a $10K monthly benefit

[23] Pages 1-5

- Not alter the amount or form of benefits under the plan (see §414(p) (3) except as provided in §414(p) (4)).[24]

Additionally, to the extent specified in the QDRO, the former spouse of the participant may be treated as the current spouse for purpose of the survivor benefit requirements. This means that if the divorce occurred after the starting date of an annuity payout under a QDRO, unless the non-participant spouse is expressly divested of the survivor benefit, the election remains valid and the benefit would be paid to the non-participant spouse.[25] Or, if the divorce occurs PRIOR to the beginning date of the annuity, the QDRO may specify that the former spouse of the participant will be treated as the current spouse in regards to a portion or the entire plan benefits.[26] Obviously, these are extremely important points to remember when drafting QDROs or reviewing another's proposed QDRO.

Finally, plan administrators must have procedures for promptly evaluating QDROs and notifying participants and alternate payees as to whether the QDRO submitted was valid.[27] The plan administrator must segregate and account for the amount that would be paid under the QDRO during the time period when the QDRO is being reviewed for validity.[28]

Thus, when dividing a nonqualified plan, employers are not required by statute to comply with ERISA QDRO rules, but most will, so draft you Non-Qualified Domestic Relations Order (NQDRO). However, the practitioner will trade the fire of the strict requirements needed to effectuate division of the plan under the QDRO rules for the frying pan of uncertainties inherent in the division of a nonqualified plan. For example, are the plan benefits assignable or even transferable? Will the plan administrator honor a Domestic Relations Order? What will the tax consequences be? Can you explain to your non-participant client how benefits will be paid? Will benefit payments be restricted to a certain time frame based on SEC or other requirements? If the participant is a top executive subject to provisions of the Sarbanes-Oxley Act, could benefits harvested by the non-participant spouse be reclaimed by the government due to financial wrongdoings of the participant spouse?

Currently the SEC has over four dozen Fortune 500 companies under investigation as to the timing of the grants of Non-Qualified Stock Options. Remember options were the drug of choice in the 1990's, not only in the Silicon Valley, but also throughout corporate America.

This investigation is focused on "insider information laws". In each option grant under investigation, the grant was made surprisingly close, but prior to the release, of favorable financial information about the company. The type of news released would be of the type that would tend to cause owning the stock to be more favorable, resulting in a market ramp-up of the trading price. Not every executive serves on the compensation committee. Many of the executives receiving the grants may have had no advance notice of the favorable news. Even without culpable criminal liability for benefiting from insider information, the result may be a forfeiture of the options.

Many companies' executives that regulators are now examining were also among the executives who decried the attempts for more stringent accounting overseers to force them to deduct option costs from corporate income statements. If you represent the executive and fight to retain the options and they wind up being forfeited [which is happening], where are you liability wise? If you represent the non-employee spouse and something of value is traded to walk with some options, the question is the same. And the answer is easy come, easy go!!

At issue may be whether a plan is controlled by ERISA. (See Example 4, Appendix B). Assume the plan was first characterized as a "Golden Parachute", and it did have the effect of cushioning the blow of the executive's termination after a power struggle in the boardroom. However, the plan had nothing to do with a change in control of the employer, so it was really not a "Golden Parachute" in the traditional sense.

The controversy again centered on the separate vs. community nature of the benefit, which, at the time of the divorce, was in pay status. If the plan was not considered an "ERISA Plan", then the benefit would seem to have accrued as a "severance package" after the date of the marriage that was being dissolved, with no opportunity to determine any separate component (vs. community) of the $75K/year benefit.

If the plan was covered by ERISA, then the plan benefit could be considered to have accrued to some extent prior to the date of marriage[29] and would also be

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[24] The plan may, however, adopt provisions that govern only distributions to alternative payees, and alternate payees may receive distributions under the plan earlier than if made to the participant. Furthermore, alternate payees may select a payment plan different from that selected by the participant as long as the participant was not in pay status at the time the QDRO was accepted (as long as the payment plan selected is allowable under the plan).

[25] Treas. Reg. § 1.401(a)-20(c), Q&A25(b)(3)

[26] Treas. Reg. § 1.401-13(g)(4)(i)

[27] IRC §414(p)(6)

[28] IRC §414(p)(7)

[29] Thus allowing a Berry/Taggart type formula to be used in the determination of community vs. separate property.

divisible by QDRO. The various attributes of the plan were brought to light in order to determine if there were enough or not enough characteristics to imply ERISA coverage. Thus, the applicability or inapplicability of ERISA on a nonqualified plan could have a significant impact on the outcome of the property division.

In 2002, the **Economic Growth and Tax Relief Act (EGTRA)** resulted in two important legislated changes for employee benefit plans:

1. Raised the total dollar amount of contribution limits; and
2. Liberalized companies use of ESOP's and 401k Plans.

Prior to EGTRA, ESOP companies that contributed the maximum amount to an ESOP [25% of the employee's annual pay] were precluded from also having a 401k Plan. The contribution limit increases allowed by EGTRA virtually eliminates the prior problem.

There are still two contribution limits that affect employer corporations:

1. The Internal Revenue Code Section 404 governs how much the employer can claim for contributions to an employee plan; and
2. The Internal Revenue Code Section 415 limits how much both employers and employees can contribute to individual employee accounts.

Pre-EGTRA, if an employee did not have a leveraged ESOP [or if the company was an S-corporation ESOP], the maximum annual contribution limit to the ESOP was 15% of the total eligible pay. Under EGTRA, the new annual contribution limit is raised to 25% of the total eligible pay for all ESOP plans.

In addition, employer corporations can take a tax deduction for the reasonable dividends (which the service defines as those "that are justified by earnings and in line with standard industry practice") paid on ESOP shares that employees voluntarily reinvest in the plan to buy more employer stock.

V. VALUATION & CHARACTERIZATION ISSUES

Many of the valuation and characterization issues relevant to qualified plans also apply to non-qualified deferred compensation plans. However, additional complexity will often apply, and the following passages attempt to demonstrate a few of these additional difficulties.

Nonqualified deferred compensation plans generally use either a "salary continuation" or "salary deferral" approach. The former provides a specified deferred amount payable in the future without any stated reduction of current salary and generally provides a "defined benefit" (investment risk borne by the plan). The latter provides a deferral opportunity for a specified amount of compensation of the employee otherwise payable (additional tax savings opportunity for participant), generally taking the form of a "defined contribution" that produces an unknown future benefit (investment risk borne by the participant).

The valuation of a defined benefit involves projections of the participant's expected date to start receiving benefits from the plan (usually retirement), the life expectancies of the participant spouse and perhaps the participant spouse, the benefit that will be received at retirement, and an appropriate discount rate that considers both the systematic and non-systematic risks involved with the plan. Once those inputs are determined, the valuation process is generally a two-step present value calculation-first, the present value (lump-sum equivalent) of the retirement annuity to be received starting at the projected retirement date is determined, and then the present value of that lump sum equivalent *as of the date of divorce* is determined. However, additional problems with respect to nonqualified plans can become apparent. For example, refer to Example 5 in Appendix B. The benefit amount appeared to change without warning, and there was no guarantee that employee would remain employed for another three years. However, the employee had recently (and successfully) concluded several significant transactions on behalf of his employer and there was no indication that he would not finish his career there. Therefore, determining and defending a value as of the date of divorce presented some obvious challenges in determining the amount of the annuity to "present value" and a discount rate to reflect the risks inherent in this plan with respect to the particular participant.

In contrast, with a qualified defined benefit plan where the employee had worked enough for at least partial vesting, these uncertainties as to amount and timing of benefit would not exist to that degree.

The valuation of the vested benefit in a defined contribution-type plan is often simpler than for a defined benefit-type plan. Often, account statements for defined contribution plans provide the answer-"it is what it is." However, participant "balances" in nonqualified deferred compensation plans might consist of nothing more than bookkeeping entries tracked by the performance of phantom stock units and any funds that have been set aside in the plan may still be subject to the risk of loss in the event the employer runs into serious financial difficulties. This problem would probably not exist in a *qualified* defined contribution plan, although such balances are subject to market fluctuations with respect to the values of the investments..

On Saturday, August 30, 2003, the Associated Press reported the following:

NYSE CEO gets new deal, huge payout
By Amy Baldwin
The Associated Press

NEW YORK - The New York Stock Exchange extended Chairman and Chief Executive Dick Grasso's contract Wednesday in a deal that included $140 million in previously accumulated savings, retirement benefits and other incentives.

The payout drew immediate scrutiny from critics as well as the Securities and Exchange Commission.

In an unusual public comment, the SEC said it was "looking into the details" of Grasso's package. SEC Chairman William Donaldson, Grasso's predecessor at the stock exchange, said the nation's stock exchanges must lead by example in setting standards for corporate governance.

Critics said Grasso's package failed to do that.

The NYSE board said the payout included $40 million in savings, $51.6 million in retirement benefits and $47.9 million in incentives.

The following passage from this article is the most important with respect to this paper and illustrates the problematic nature of quantifying nonqualified plan benefits:

It's not clear how Grasso's deferred funds accumulated or at what rate, since the NYSE is a private, not-for-profit company and has not made those details public.

Thus, a family law attorney might have some difficulty discovering all of the details about this monumental compensation package. A tax attorney quoted in the article stated:

"His compensation must have been much higher in the past, or he had substantial bonuses or prior awards [and/or] he could have deferred a substantial portion of his compensation, and he may have had access to good investment advice and may have made great investment choices."

At the time of Wednesday's announcement, Grasso, 57, said he was withdrawing the funds "in order to facilitate personal financial planning and estate planning."

Read: Take advantage of low tax rates and paying the tax now reduces amount subject to estate tax. Therefore, the tax tail wags the dog, as is often the case.

If payout is a long way in the future, the non-participant spouse may be better off taking a share of the as-yet-undetermined benefit, as current values can be quite small on a risk-adjusted, present value basis, especially in a defined benefit type arrangement. Or, if the non-participant spouse has an urgent need for liquidity, they may consider whether to take a small equivalent payment out of other assets to make up for the voluntary "forfeiture" of their "share" (if any) of present or future benefits.

The following illustrates the possible wisdom of a non-participant spouse implementing a "take the money and run" strategy:

Spitzer seeks $100M from Grasso

N.Y. attorney general announces sweeping lawsuit seeking return of some of $187M pay package.
May 24, 2004: 5:38 PM EDT
By Krysten Crawford, CNN/Money staff writer

NEW YORK (CNN/Money) - New York Attorney General Eliot Spitzer filed a lawsuit against former New York Stock Exchange Chairman Richard Grasso and the exchange Monday, seeking the return of some of Grasso's $187 million pay package.

Source: Cnn.com

Spitzer's suit alleges that:

- **The NYSE Board of Directors was misled on various aspects of the Grasso compensation contract.**

Inaccurate and misleading information in the form of incomplete and incorrect analyses were provided to Board members. Frank Z. Ashen, a top deputy to Grasso, admitted providing "incomplete, inaccurate and misleading" information in documents to the Board. In one example, the Board was not aware of $18 million in so-called Capital Accumulation Plan (CAP) bonus awards to Grasso for 1999-2001. In addition, Mercer Human Resource Consulting, Inc., a consultant asked to prepare a financial analysis of a proposed $187.5 million payment to Grasso, has admitted that its report to the Board contained "inaccuracies and omissions."

- **The compensation formula that generated huge payments for Grasso was flawed and under Grasso's control.**
  The compensation formula was inappropriately driven by a comparison with the salaries of top executives in the world's largest corporations. In addition, the investigation found that Grasso, in effect, set his own performance targets, which he easily exceeded. In any event, the NYSE disregarded its own formula on numerous occasions and awarded Grasso funds well beyond the formula's product.

- **The compensation provided to Grasso was not "reasonable" according to state law.**
  New York Not-for-Profit Law requires that compensation for executives be "reasonable" and "commensurate with services provided." In this case, however, the compensation far exceeded what would have been permitted by that standard. Indeed, the amount expended by the NYSE for Grasso's compensation and benefits for 1999 through 2001 nearly equaled the NYSE's total net income for those years.

- **Grasso's dual role as regulator and NYSE employee raised a conflict of interest.**
  Heads of major Wall Street investment banks were also members of the Compensation Committee. During the same period they approved Grasso's excessive pay packages they had joined him in a private SEC-sponsored meeting at which they were assured that analyst conflicts of interest were "for the industry to resolve" without regulatory action.

Source: New York Attorney General's Office

The Grasso lawsuit should go to trial in the summer of 2006.

Many of the same characterization issues relevant to qualified plans also must be dealt with in non-qualified plan balances. Prior to September 1, 2005, defined benefit arrangements were susceptible to characterization under a Berry/Taggart type formula, and defined contribution plans were subject to characterization based on a simple "subtraction" method (i.e. what is the balance of the plan now vs. that as of the date of marriage, the difference being community property and the remainder the separate property of the participant).

Recent amendments to the Texas Family Code brought significant changes to allowable methods for the tracing and characterization of defined benefit and defined contribution plans. Defined contribution plans are now subject to tracing (Section 3.007(c)) using the tracing and characterization rules subject to non-retirement assets.

Section 3.007(a) and (b) address the characterization of interests in defined benefit plans. The separate property interest is defined as "the monthly accrued benefit that the (participant) spouse had a right to receive on normal retirement age, as defined by the plan, as of the date of marriage, regardless of whether the benefit had vested. The community interest in a defined benefit plan is defined as being "determined as if the spouse began to participate in the plan on the date of marriage and ended that participation on the date of dissolution or termination of the marriage, regardless of whether the benefit had vested."

Commentators[30] have set forth analyses of this provision, showing that it has the potential to not characterize 100% of a defined benefit. A solution to this problem was proposed as House Bill 100, introduced in the 1st Special Session of the 79th Legislative Session. The proposed change to Section 3.007(a) and (b) would have codified the general time rule contained in the Berry/Taggart/May cases:

Months of plan participation during marriage

divided by:

Months of plan participation

The resulting fraction would be applied to the benefit accrued at the date of divorce, regardless of whether or not the benefit was vested to obtain the community property interest in the plan benefit, with the balance being the separate estate's interest. The proposed change provided that the community would share in post divorce plan adjustments and cost-of-living adjustments to the extent of the community percentage. However, this amendment died when the special session expired. Uncertainty currently exists among family lawyers regarding the application of Section 3.007(a) and (b).

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[30] Anderson , "History of Employee Compensation Plans" State Bar of Texas 31st Annual Advanced Family Law Course, 2005, Chapter 57.1 and Westhoff , "Legislative Update: Family Law" Dallas Bar Association September Section Meeting, Dallas, TX

As a general proposition, most participants in non-qualified deferred compensation plans (stock options being the notable exception) do not become eligible to participate in these plans until later in their careers or as their compensation increased to certain thresholds that cause limitation or curtailment of qualified plan benefits. Therefore, even if the participant is a longtime employee, benefits from nonqualified plans may still be mostly community in nature with respect to a second marriage.

VI. DISCUSSION OF TAX ISSUES RELATED TO THE DIVISION OF NONQUALIFIED PLANS.

An expedient way to illustrate the tax issues involved in the division of non-qualified deferred compensation plans is to review some of the aspects of stock options.

A. Review of Stock Option Issues

Many individuals are participants in their employers' stock option plans, and unvested and vested stock options often comprise a significant amount of their net worth. Stock options are compensation devices that are often directed only to employees whose efforts will have a direct impact on the price of the stock. Unlike ESOP's or investments in employer stock by retirement plans, stock option plans often require that the employee put his personal, liquid capital at risk, which should enhance the quality of the employee's efforts even further if the optioned stock is to be held for any length of time.[31]

Employees are generally granted one of two different types of compensatory stock options: nonqualified (NSO) or incentive (qualified, statutory, or ISO). Most often, an employee has one or the other, but the same employee may be part of the same company's ISO and NSO plans. ISO's are less common and are more typically granted to executive management due to the more favorable tax consequences involved. Also, ISO's are, by definition, nontransferable, so if they transferred in a divorce, they become NSO's.

Stock options are often valued by the "intrinsic value method," which is simply the difference between the fair market value of the underlying stock vs. the strike price of the option. If the stock price is less than the strike price, the option has no inherent value at that time, except perhaps as an expectancy or contingent worth, especially if there is a reasonable possibility that the fair market value could approach the strike price in the near future. The tax liability associated with the exercise of the options could also be taken account under this method. Many larger companies have options traded on public markets, and an NSO could be valued by reference to the public market if comparable options were available.

For the (potentially) more technically accurate value estimate, options can also be valued by use of the "Black-Scholes Option Pricing Method" which is essentially a two part calculation.

The first part of the calculation is the expected benefit from acquiring a stock outright. This is found by multiplying the stock price by the change in the option premium with respect to a change in the underlying stock price. The second part of the model gives the present value of paying the exercise price on the expiration day. The fair market value of the option is then calculated by taking the difference between these two parts. The reader is directed to http://bradley.bradley.edu/~arr/bsm/model.html for a brief history and understandable explanation of this option pricing model.

With regard to the characterization of options as separate or community property, the key issue is often how much, if any, of unvested options are assets of the community estate. Prior to the enactment of HB 410, key questions that were asked in this regard are:

- Were the options granted as an inducement to come to work for the employer or
- Were the options granted as a reward for longtime service?
- What is the grant date of the options? Is this the inception of title?
- What are the vesting dates of the options and expiration dates of the options?
- What are the key terms of the option plan?
- Will the participant is limited in terms of windows or opportunities to exercise options due to his or her position with the company?
- Are the options a substitute, in whole or in part, for current compensation (i.e. would the participant's salary be below market if not for the options?)
- What does the participant have to accomplish, if anything, other than showing up to work and doing a decent job in order to retain the options?

New Section 3.007(d) provides a fairly straightforward mechanism for the division of unvested stock options.[32] The mechanism consists of a time rule, applied differently to options granted prior to marriage and those granted during the marriage.

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[31] With a few notable exceptions, it is the author's personal observation that among his tax clientele and with respect to litigation cases, almost all stock acquired by option exercise (especially NSO's) is immediately sold.

[32] Also applies to restricted stock

For options granted before the marriage, the participant spouse's separate property interest is determined by a fraction measured by time applied to the number of options within the grant:

Date of Marriage minus Date of Grant, divided by

Date of Vesting minus Date of Grant

For this purpose, the Date of Vesting is defined as the date the option could be exercised or the date the restrictions were removed.

For options granted during the marriage, the apportionment fraction is computed as follows:

Date of Vesting – Date of Divorce, divided by

Date of Vesting – Date of Grant.

Appendix C to this paper shows a calculation done for a recent trial that characterized unvested options granted during a marriage. These calculations were validated by opposing counsel (for the most part). The application of the statute is straightforward, so agreement regarding the character of stock options in many cases should not be difficult.

As stated by Jack Marr in his recent paper entitled "Stock Options,"[33] grants of options are often made with specific layers or tranches, with each layer vesting on a different date. Therefore, each layer will be subject to a different characterization percentage using the methodologies outlined above. This issue is illustrated in Appendix C. Mr. Marr also notes that the statute does not distinguish between non-qualified (NSO's) options, and qualified (ISO's) options. Additionally, the statute does not address situations where the exercise date is dependent upon future conditions rather than a specific date in the future. In that situation, the factors mentioned in the bullet points on the previous page may need to be revisited and considered.

NSO's are taxed under IRC § 83, which deals with the receipt of property for services. Most NSO's do not have a readily ascertainable fair market value at the time of their grant because the strike price of the option is higher than the current market price and/or the employee must fulfill a length of service requirement before the options can be exercised. If that is the case, the employee is not taxed at the grant of the option. Rather, the employee is taxed when he exercises the option (as opposed to vesting); regardless of the fact that the option may be "in-the-money" at the vesting date and the option is not exercised until later. The amount subject to taxation (and the amount deductible as compensation by the employer) is the fair market value of the stock acquired over the amount of money paid by the employee to exercise the option. The amount recognized as income by the employee plus the amount paid to exercise the option becomes the employee's basis in the stock, and the holding period begins on the date of exercise. If the stock is held after the option is exercised, capital gain or loss results on the ultimate disposition of the stock, depending on the amount realized.

If the employee desires to transfer the options (and such a transfer is permitted by the plan), IRC §83 also governs that transaction. Such a transfer could be in an arms-length transaction or a non-arms length transaction.

In an arms-length transaction, the transferor realizes compensation in an amount equal to what he receives for the option.[34] The purchaser of the option has a basis in the option equal to the same amount. If and when the purchaser exercises the option, no additional income is recognized either by the former or current holder of the option. This is because for tax purposes, the sale of the option in the arms-length transaction "closed" the compensation element to the seller.

In the case of the exercise of the option by the purchaser, the basis of the option is added to the basis of the stock acquired and the later sale of the stock results in capital gain or loss, as the case may be. If the option expired worthless, it would be a capital loss in the hands of the purchaser.

If the transaction was a NON arms-length transaction, the compensation element of the option remains open with respect to the transferor. For example, say the transferor gave the options as a gift to his or her child. When the child exercised the options, the transferor would still recognize ordinary income in an amount equal to the fair market value of the stock as of the date of exercise over the amount the child paid to exercise the options. The basis of the stock acquired by the transferee will be equal to the amount of income recognized by the transferor plus the amount paid by the transferee to exercise the option.

As stated previously, §1041 of the IRC generally allows for tax-free transfers of property incident to a divorce. In fact, § 1041(b) states that such transfers are treated as gifts for tax purposes, meaning the transferee takes a carryover basis in the property transferred and recognizes no gain on the transfer.

Therefore, it would seem that the transfer of an option incident to divorce would be treated as a gift,

[33] State Bar of Texas, 31st Advanced Family Law Course, August 2005, Chapter 57.2.

[34] Treas. Reg. Sec. 1.83-1(b)(1)

and therefore the transfer would be considered non-arms-length for purposes of determining the tax consequences to the transferor and transferee.

However, the IRS, in FSA (Field Service Advice) 200005006 (02/04/00), stated that they are of the opinion that the transfer of options pursuant to a divorce decree is an arm's-length transaction, because the exchange is for the release of "other marital rights or properties in an arms-length transaction and the properties exchanged were of equal value". Options are discussed more thoroughly here because the FSA was issued with the intent of providing guidance on the transfer of options.

So, under the holding of the FSA, the transferor of options incident to divorce would recognize compensation income *equivalent to the fair market value of the options at the time of transfer*.[35] Furthermore, when the transferee spouse exercises the options, there is no taxable event to either party.

The IRS further opined that the purpose of §1041 is to shield taxpayers from the recognition of gain (in a divorce setting), as opposed to *compensation income*. Also, they reason that since compensation income is ordinary income, the income element inherent in a transferred option cannot be shielded by § 1041.

It does appear that the IRS may be shortchanging the government with this opinion. If the Service took the position that the transfer was NOT arms-length, the government would potentially be able to impose ordinary income tax on the gain inherent in the option when exercised. Instead, they want to close the compensation element of the option and its value upon its transfer. However, this value may be little or nothing in many cases.

IRC §83, as stated above, provides that nonqualified options are not taxed at grant, if they have no "readily ascertainable fair market value". The IRC dictionary definition of this term is *either* 1) the option is actively traded on an established market or 2) the value can be determined with reasonable accuracy. Reasonable accuracy occurs when an option possesses *all* of the following attributes: 1) the option is transferable, 2) option is immediately exercisable, 3) option is not subject to restrictions which would impact the value and 4) the fair market value of the option privilege is readily ascertainable in accordance with the regulations issued under § 83 of the IRC. Therefore, if unvested options in a closely held company are transferred incident to divorce and the holding in the FSA is followed, it seems that the §83 would not allow for any value to be attributed to the options.

However, if an unvested, but actively traded option is transferred, it seems §83 would require the practitioner to become versed in the Black-Scholes option pricing model or other valuation method in order to determine the tax consequences to the transferor and transferee!

The above FSA can only be applied with certainty to situations arising in common-law states. In the PLR's discussed in Section II of this paper, the IRS ruled that no *transfer* of an option would occur in a community property state, since the non-employee spouse would already possess a one-half community interest in the options. It is unclear; however, if the IRS intended their position in the FSA to apply to community-property states since the FSA is silent in that regard.

The IRS did issue additional guidance on this issue in 2002, and expanded the guidance to involve nonqualified deferred compensation in the generic sense. Revenue Ruling 2002-22, which was perhaps a response to criticism of FSA 200005006, and specifically, the impractical result it requires and the uncertainty of its application in community property states, provides that:

- A taxpayer who transfers interests in nonstatutory stock options and nonqualified deferred compensation to the taxpayer's former spouse incident to divorce[36] is not required to include an amount in gross income upon the transfer;
- The former spouse, and not 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

The effect of this is to clear up the confusion from the FSA and remove a tax inefficiency inherent in many divorces-the non participant spouse having to pay tax on the options or deferred compensation at the participant spouse's higher rate. Also, it may remove the need to have the payments funneled through the participant's wage reporting structure and then paid, net of the higher tax rate, from the participant spouse to the non-participant spouse. However, Revenue Ruling 2002-22 will not apply to the extent the options or deferred compensation is not vested or subject to substantial contingencies at the time of the transfer. Another key observation is that if the benefits are merely *assigned* to the non-participant spouse through the appointment of the participant spouse as constructive trustee or similar arrangement, the IRS may not view this ruling as applicable. I recently spoke with a representative of the IRS familiar with this ruling, and she said that the IRS may rule on

[35] FSA200005006, p4

[36] Assuming within the meaning of that term in IRC §1041

exactly what constitutes a "transfer" for this purpose, but a ruling on that matter was not high on the IRS' priority list.

If Revenue Ruling 2002-22 does not apply, the divorcing spouses and their advisors will find themselves struggling for guidance from the FSA and PLR's discussed above.

After 2002-22 was issued, the IRS also issued Notice 2002-31, which was to provide proposed rules for the wage and payroll tax reporting incident to a transfer of nonqualified deferred compensation benefits. This guidance also caused controversy and misunderstanding, but the interpretation from the IRS is as follows:

- Nonemployee spouse subject to income tax withholding on the distribution of taxable non-qualified plan benefits;
- Nonemployee spouse subject to FICA withholding;
- Employee spouse gets the credit for the FICA withholding (i.e. will not assist the nonemployee spouse's future social security benefit);
- Income tax levied on gross benefit, without taking into account the FICA withheld;
- Employer pays it's half of FICA on the distribution;
- Tax and withholding reported on 1099-Misc.

These provisions were adopted as the official position of the IRS in Revenue Ruling 2004-60, Internal Revenue Bulletin 2004-24 (06/07/04).

Therefore, the employer is placed in the position of having a non-employee on the "payroll," so to speak, which may be somewhat awkward. Therefore, employers may prefer to see the benefit divided as an assignment, and will no doubt enforce provisions of plans that prohibit actual transfers from one party to another.

VII. USE OF EXPERTS; RESOURCES

A. Use of Experts

The practitioner may find the help of an expert useful in dealing with the issues presented in this paper. An attorney who specializes in employee benefit plan issues may be of assistance in this regard as could a seasoned CPA with experience in employee benefit and personal financial planning issues. A good, knowledgeable expert can be very valuable in providing assistance in determining the most relevant documents needed to understand the plan and its benefits and providing written memoranda on exactly what the plan is in terms of when the employee began to participate, the type of benefit involved, the current value of the benefits accrued as of the date of the divorce[37], the tax impact of current, impending, and future distributions from the plan and other issues. Experts can provide these services with respect to both qualified and non-qualified plans. However, the attorney will also have to become very familiar with the terms of the plans and understand the issues relating to their operation and value to the community and/or separate estates of the parties.

B. Sources of Information

It should be mentioned that experts should have a wealth of information, including secondary tax research services that will assist and support their facts and opinions concerning these types of plans. For example, the Bureau of National Affairs (BNA) Tax Management Portfolios have several volumes dedicated to employee benefits issues. These portfolios are a basic component of a tax research library. Useful (and often free) information abounds on the internet as well and the expert can be useful is searching for these additional resources. For example, a useful website is Benefits Link: **http://www.benefitslink.com/**.

ACKNOWLEDGMENTS

I acknowledge my Partner, Kimberly Naylor and Bryan Rice of Hartman, Leito and Bolt, L.L.P. and appreciate their generous giving of their time in co-authoring this article. I additionally want to thank Brenda Keen for the use of material she has presented on this and similar topics. I also want to thank and acknowledge the authors of the following publications for their contributions as a resource for the writing of this article. I recommend them as a very informative and understandable resource for information on this topic.

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"Family Law Meets Uncle Sam-Non Qualified Stock Options" authored by Edwin Davis, Felicia A. Finston and Shane Tucker, February 2001, Texas Academy of Family Law Specialists Trial Institute.

"Erisa's Curious Coverage" authored by Peter J. Weidenbeck , 76 Wash. U. L.Q. 311. A version of this article will appear as chapter 3 in a forthcoming book on the labor law provisions of ERISA, Peter J. Wiedenbeck, ERISA in the Courts.

"IRS on the Warpath: Executive Compensation-References and Forms" authored by Brenda Keen and presented to the 15th Annual Trial Institute, Texas

[37] For a defined benefit, actuaries may have to be consulted to obtain a more precise estimate of value based on the parties' ages, life expectancies, etc. Certain firms are able to provide very economical reports of value for defined benefits based on a fairly limited amount of information.

Academy of Family Law Specialists, February 22-23, 2001.

The U.S. Department of Labor Benefits Security Administration has a user friendly website. It provides a wealth of information including recent IRS rulings, QDRO explanation forms and more. See **www.dol.gov/ebsa**.

BNA Tax Management Portfolios:

Wofford 515 T.M. Divorce and Separation

Brisendine et. Al. 385-4th Deferred Compensation

Kushner 361-4th Reporting and Disclosure Under ERISA

Research Institute of America, Analysis of the American Jobs Creation Act of 2004

2002 Pension Plan Comparison Chart—See Page 14-4 for 2001 Tax Act Changes

	IRA IRC §408	SEP IRA (Self-Employed) 408(k)	SEP IRA (Employee) 408(k)	SIMPLE-IRA IRC §408(p)
Qualifications for Plan	Anyone under age 70½ with earned income. Full deduction if taxpayer is not active participant in an employer retirement plan. Phaseout rules apply if an active participant.	Anyone with SE income. Contributions are treated same as an IRA.	Eligible employees include anyone at least age 21 who worked three of the last five years and received at least $450 in the calendar year.	Employers with 100 or fewer employees (including self-employed individuals) that do not currently maintain another retirement plan. Must be offered to all employees who have earned at least $5,000 in any prior two years, and are reasonably expected to earn at least $5,000 in the current year.
Maximum Contributions Allowed (3)	Each spouse can contribute up to $3,000 or their earned income amount, whichever is less. A nonworking spouse can also put up to $3,000 into a spousal IRA. Limit increases to $3,500 for participants age 50 or older.	20% of net SE income after SE tax deduction up to maximum contribution of $40,000.	25% of wages up to maximum contribution of $40,000. SARSEPs established prior to 1997 follow 401(k) contribution limit rules.	Employee elective deferrals limited to $7,000 (7,500 if age 50 or older). Employer can either match dollar for dollar employee elective deferrals up to 3% of wage (can be reduced to as low as 1% in any two out of five years), or contribute 2% of wage up to $4,000 for *all* employees (including nonparticipants).
Penalties for Early Withdrawal Before Age 59½	10% of distribution. (See exceptions on next page.)			10% of distribution, or 25% if withdrawn less than two years from date first participated in plan. (See exceptions on next page.)
Age at which Withdrawals Must Begin	70½ (5)	70½: Contributions can still be made to the plan after age 70½ if there is still earned income. [Compare IRC §219(d)(1) with IRC §219(b)(2) for SEPs and with IRC §219(b)(4) for SIMPLEs.]		
Date to Start Plan and Make Contributions	Return due date—no extensions.	Return due date, including extensions.		• Establish plan: By October 1, 2002 for new plans first in effect for 2002. (2) • Make employer contributions: By return due date including extensions. (9)
Annual Contributions Required?	No	No	No	Yes
Borrowing Permitted?	No	No	No	No
Does a Lump-Sum Qualify for Averaging? (8)	No	No	No	No
Rollover? (1)	Yes	Yes	Yes	Yes
Penalty for Excess Contributions? (6)	6%—However, person has until the due date (including extensions) to withdraw excess with no penalty. Withdrawal must include income earned (which is subject to the 10% early withdrawal penalty if no exceptions apply).	6% excise tax for both self-employed individuals and employees if excess (plus earnings) is not withdrawn by return due date. Employers are subject to a 10% excise tax on nondeductible (excess) contributions unless exceptions apply.		10% penalty

Advantages to Plans

Qualified plans:
- Contributions (including IRAs, SEPs, SIMPLEs) are generally tax deductible by the contributor and tax deferred for the plan participant. Contributions plus earnings are tax deferred until withdrawn.
- Maximum contributions (including SEPs and SIMPLEs) are generally greater than IRAs.
- Lump-sum distributions may qualify for 10-year averaging.

IRAs and SEPs:
- No annual reporting requirements; easy to administer.
- Does not require recurring contributions.

SEPs and qualified plans. Can still make deductible contributions after age 70½.

IRAs, SEPs and Keoghs:
- Allow plan participant to choose investment as opposed to a plan administrator through employer.
- Tax refund can be used to fund the contribution since due date to contribute is tax filing date including extensions (no extension for IRA).
- Participant is always 100% vested in the plan [also includes employee contributions to 401(k), 403(b) and SIMPLE plans].

401(k) and 403(b) plans:
- Employers allowed to match employee contributions; employee is generally fully vested sooner than with other qualified plans.
- Plan is managed by professionals.
- Easy for employees—contributions through payroll reductions.
- Certain tax-free borrowing from plan is permitted.

SIMPLE plans. Similar to 401(k) employee elective deferral and employer matching, without complex nondiscrimination and "top-heavy" rules.

Nonqualified deferred-compensation plans:
- Plan can discriminate in favor of key employees.
- No contribution limits or funding requirements.

Disadvantages to Plans

Qualified plans, IRAs, SEPs and SIMPLEs:
- For young participants, money will be tied up for many years. Emergencies may tempt participants to withdraw funds with substantial tax and early withdrawal penalty costs.
- If tax rates increase, or tax laws change, withdrawals may cost more than the tax savings when originally contributed.

IRAs:
- At age 70½, no longer able to make contributions.
- Maximum contributions are generally less than SEPs and other qualified plans.

Money-purchase plans. Same percentage of income earned must be contributed each year.

Nonqualified deferred-compensation plans:
- Employer contributions generally not deductible until included in employee's income.
- Plan earnings are generally not tax deferred.
- Employee assumes risk that some or all funds may be lost. No minimum funding or vesting rules to protect employee.

Footnotes:
1) If a company forces a person to take funds out before he/she is allowed to, he/she may qualify to roll the funds into an IRA and avoid the 10% penalty on early withdrawals.
2) New employers who come into existence after October 1 may establish plan as soon as administratively possible.
3) If there is a net loss from self employment, do not reduce other wages by the loss when calculating the maximum contribution.
4) If under a divorce decree a spouse transfers his or her interest in an IRA to the former spouse, then the transfer is not taxable. However, if funds are withdrawn from the IRA under a divorce decree and given to the former spouse, the distribution is taxable

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Pension Plan Comparison Chart—2001 Tax Act Changes

Maximum Contributions Allowed for:	2001	2002	2003	2004	2005	2006
Traditional and Roth IRAs—under age 50	Lesser of $2,000 or earned income.	Lesser of $3,000 or earned income.			Lesser of $4,000 or earned income.	
Traditional and Roth IRAs—age 50 or older	Lesser of $2,000 or earned income.	Lesser of $3,500 or earned income.			Lesser of $4,500 or earned income.	Lesser of $5,000 or earned income.
SEP	15% of wages up to $25,500 (13.0435% of net SE income after SE tax deduction for self-employed). Compensation limit = $170,000.	25% of wages up to $40,000 (20% of net SE income after SE tax deduction for self-employed). Compensation limit = $200,000.				
SIMPLE—under age 50	Employee elective deferrals = lesser of $6,500 or earned income. Employer must match up to 3% of wage.	Employee elective deferrals = lesser of $7,000 or earned income. Employer must match up to 3% of wage.	Employee elective deferrals = lesser of $8,000 or earned income. Employer must match up to 3% of wage.	Employee elective deferrals = lesser of $9,000 or earned income. Employer must match up to 3% of wage.	Employee elective deferrals = lesser of $10,000 or earned income. Employer must match up to 3% of wage.	Employee elective deferrals = lesser of $10,000 or earned income. Employer must match up to 3% of wage.
SIMPLE—age 50 or older	Employee elective deferrals = lesser of $6,500 or earned income. Employer must match up to 3% of wage.	Employee elective deferrals = lesser of $7,500 or earned income. Employer must match up to 3% of wage.	Employee elective deferrals = lesser of $9,000 or earned income. Employer must match up to 3% of wage.	Employee elective deferrals = lesser of $10,500 or earned income. Employer must match up to 3% of wage.	Employee elective deferrals = lesser of $12,000 or earned income. Employer must match up to 3% of wage.	Employee elective deferrals = lesser of $12,500 or earned income. Employer must match up to 3% of wage.
Money-Purchase Defined-Contribution Plan	25% of wages up to $35,000 (20% of net SE income after SE tax deduction for self-employed). Compensation limit = $170,000.	Contributions per participant up to lesser of 100% of compensation or $40,000. Compensation limit = $200,000. Employer deduction limited to 25% of aggregate compensation for all participants (20% of net SE income after SE tax deduction for self-employed).				
Profit-Sharing Defined-Contribution Plan	15% of wages up to $25,500 (13.0435% of net SE income after SE tax deduction for self-employed). Compensation limit = $170,000.	Contributions per participant up to lesser of 100% of compensation or $40,000. Compensation limit = $200,000. Employer deduction limited to 25% of aggregate compensation for all participants (20% of net SE income after SE tax deduction for self-employed).				
401(k)	Employee elective deferrals limited to $10,500. Employer deduction limited to 15% of combined wages of all employees (elective deferrals must reduce wages for purposes of the 15% limit). Combined employer contributions and employee elective deferrals per employee limited to 25% of wage up to $35,000.	Employee elective deferrals limited to $11,000 ($12,000 for employees age 50 or older). Employer deduction limited to 25% of combined wages of all employees (elective deferrals do not reduce wages for purposes of the 25% limit). Combined employer contributions and employee elective deferrals per employee limited to 100% of wage up to $40,000.	Employee elective deferrals limited to $12,000 ($14,000 for employees age 50 or older). Employer deduction limited to 25% of combined wages of all employees (elective deferrals do not reduce wages for purposes of the 25% limit). Combined employer contributions and employee elective deferrals per employee limited to 100% of wage up to $40,000.	Employee elective deferrals limited to $13,000 ($16,000 for employees age 50 or older). Employer deduction limited to 25% of combined wages of all employees (elective deferrals do not reduce wages for purposes of the 25% limit). Combined employer contributions and employee elective deferrals per employee limited to 100% of wage up to $40,000.	Employee elective deferrals limited to $14,000 ($18,000 for employees age 50 or older). Employer deduction limited to 25% of combined wages of all employees (elective deferrals do not reduce wages for purposes of the 25% limit). Combined employer contributions and employee elective deferrals per employee limited to 100% of wage up to $40,000.	Employee elective deferrals limited to $15,000 ($20,000 for employees age 50 or older). Employer deduction limited to 25% of combined wages of all employees (elective deferrals do not reduce wages for purposes of the 25% limit). Combined employer contributions and employee elective deferrals per employee limited to 100% of wage up to $40,000.
403(b)—under age 50	Employee elective deferral portion only = $10,500.	Employee elective deferral portion only = $11,000.	Employee elective deferral portion only = $12,000.	Employee elective deferral portion only = $13,000.	Employee elective deferral portion only = $14,000.	Employee elective deferral portion only = $15,000.
403(b)—age 50 or older	Employee elective deferral portion only = $10,500.	Employee elective deferral portion only = $12,000.	Employee elective deferral portion only = $14,000.	Employee elective deferral portion only = $16,000.	Employee elective deferral portion only = $18,000.	Employee elective deferral portion only = $20,000
Employer Qualified Defined-Benefit Plan	Actuarially determined contribution. Limit on benefits received equals 100% of average compensation for highest three years not to exceed $140,000. Compensation limit = $170,000.	Actuarially determined contribution. Limit on benefits received equals 100% of average compensation for highest three years not to exceed $160,000. Compensation limit = $200,000.				

Note: Dollar limits are also indexed for inflation for various items on this chart depending on the year in question. This chart is not intended to present all of the exceptions to the rule. IRA limits increase to $5,000 in tax year 2008 and beyond with the age 50 or older limit increasing to $6,000. The age 50 or older increase in elective deferrals for 401(k) plans also applies to SARSEPs.

Examples of Non-Qualified Plans Encountered:

Ex. 1: Excess Benefit Plan:

$20,000/month payment for life upon retirement, with option to take in lump sum of approximately $2 million. Same *formula* used for determination of benefit as for the company's *qualified* defined benefit plan. Participant attempted to characterize the $20,000 payment from the non-qualified plan as a "component" of the qualified plan.

Ex. 2.: Incentive Plan

$1 million bonus paid in cash if the executive's company was awarded a certain contract or any part thereof. Only one executive was benefited under this plan, which was formalized in a document. Award of contract pending during divorce action.

Ex. 3.: Stock-performance based Plan

Payment based on performance of company stock vs. stock market index for rolling two year periods. One-half of award paid in cash, remainder placed in "phantom stock" units with a two year vesting, but payable in cash upon retirement.

Ex. 4.: Ousted Executive's "Retirement Package"

High-Level Executive in Fortune 500 Co was terminated when he was 60, one year from vesting in qualified defined benefit plan. Company purchased a deferred joint-and survivor annuity that would pay $75K/year upon Exec attaining age 65, $37.5K/year to his spouse after his death. Executive could not compete with company and had to comply with other terms during five year intervening period. Arrangement was unique w/respect to Exec.

Ex. 5: Golden Parachute

Executive group of Fortune 500 Co. had "Officer's Deferred Comp. Plan." Was funded with insurance and paid a ten-year level defined benefit upon retirement expressed as a lump sum divided by 10 (e.g. $3MM/10 = $300K/year). The lump sum amount increased periodically at the apparent whim of the compensation committee. Immediate vesting upon a change in control (Golden Parachute). Employee was 52 at time of divorce, with graded vesting in the benefit starting in three years.

Ex. 6: Tax-Savings/Supplemental Retirement Funding

Executives of Fortune 500 Co. had option to defer bonuses, salary, gains from stock options, and restricted stock vesting into two different deferral plans. (one plan for bonuses/salary, another for options/restricted stock). Deferral into the plans accomplished tax deferral but caused parties in divorce significant loss of liquidity, as withdrawals from plans essentially not available until termination of employee. Significant portion of value deferred had to go to phantom stock units, causing high concentration in a single stock.

Ex. 7: Retirement Plan

Retirement package for executives of financial services firm structured as a partnership. "Executive Retirement" funded from three sources:

Total retirement benefit based on "high five" earnings

Each year's benefit paid from:

Tranche A: Qualified Defined benefit plan, up to IRS limitation. If shortfall, fund remainder from:

Tranche B: Executive's HR-10 (Keogh Plan), also a qualified plan. (Funding from this source reduces amount available for next year's funding). If shortfall, fund remainder from:

Tranche C.: Firm earnings set aside for executive retirement (non-qualified plan)

Ex. 8:

1. Defined Benefit Plans for partners of "mega" law firm (similar to Ex. 7):

Nonqualified Plan-annual benefit for life, firm contractually obligated for a minimum of ten years of payments, 1/3 of first $500M and 1/5 of next $1MM of partner's average partnership distributable income (Average PDI) (calculated prior to partners pension cost and other reductions), Avg. PDI based on ten highest earnings years of a partner with the firm, except if participant became a partner prior to 01/01/85, based on three highest non-consecutive earnings years. Maximum benefit is $500M per year. Benefit is offset by benefits firm funds with pre- tax dollars to various qualified plans

Ex. 9: Plan to compensate agents of a national financial services firm:

The agent is eligible to begin receiving monthly payments under the "incentive plan" starting in the agent's 15th "service year." A "service year" is 12 consecutive calendar months starting with the agent's contract date.

The plan rewards agents for sales using differing factors applied to sales that occur in the first, second, and third five service years.

Post divorce increases in the monthly payment are possible based on a look back to sales made during and after marriage. Payments from the incentive plan cease upon the agent's retirement.

If the agent's monthly incentive plan payment at the time of his retirement is greater than his monthly payment under the company's qualified pension plan, the difference will be paid to the agent from a non-qualified pension plan maintained by the company. If the agent's monthly incentive plan payment is less than the monthly payment under the qualified pension plan at the time of retirement, no payment will be received from the non-qualified pension plan.

Common Types of Non Qualified Deferred Compensation Plans

1. Excess Benefit Plan (Defined Benefit)
2. Excess Benefit Plan (Defined Contribution)
3. Salary or Bonus Deferral
4. Non Qualified Stock Options
5. Restricted Stock
6. Stock Purchase Plan
7. Company Provided Life Insurance (Split Dollar)
8. Stock-Price based performance plan (Stock Appreciation Rights)
9. Golden Parachute (payment based on change in control of employer)

"Phantom Stock" is often used to track participant "accounts" in non-qualified deferred comp plans, especially those used to replace "lost" benefits from qualified defined contribution plans, deferred bonuses, and stock-price based plans.

Indicia of the Existence of Non Qualified Plan benefits:

▪Highly compensated or Executive Management
▪High Salary and Long Term employee
▪Deferral of amounts in excess of IRS Limits:
▪Current payment of FICA tax on benefit accruals

Sources of Information

▪Pay stubs and Reconciliation of year-end Pay stub to W-2
▪Proxy statement information for public companies
▪Summary of Annual Benefits received from employer
▪Interviews with HR personnel of Company
•Plan Documents
•Correspondence from HR department
•Personnel File
▪Compensation history (can indicate when employee was first eligible for plan)

Appendix C
Schedule of Stock Options

XYZ Price: $50.00

Date of Divorce 7/13/2006

Date Granted	Date Vested	Total Shs	Shares Vested	Strike Price	Comm. Percentage	Separate Percentage	Comm. Shares	Separate Shares	Community Value	Separate Value
Completely Vested Options										
5/19/1997		6,000	6,000	$24.41	100.00%	0.00%	6,000	0	$153,570	$0
5/18/1998		5,800	5,800	$32.03	100.00%	0.00%	5,800	0	$104,226	$0
5/19/1999		5,600	5,600	$43.78	100.00%	0.00%	5,600	0	$34,832	$0
5/10/2000		5,600	5,600	$50.88	100.00%	0.00%	5,600	0	$0	$0
9/21/2001		1,463	1,463	$43.50	100.00%	0.00%	1,463	0	$9,510	$0
7/22/2002		1,800	1,800	$32.25	100.00%	0.00%	1,800	0	$31,959	$0
Non or Partially Vested										
5/15/2001		5,600	4,480	$52.81	100.00%	0.00%	4,480	0	$0	$0
	5/15/2006		1,120	$52.81	103.27%	-3.27%	1,157	-37	$0	$0
5/6/2002		5,200	3,120	$50.31	100.00%	0.00%	3,120	0	$0	$0
	5/6/2006		1,040	$50.31	104.70%	-4.70%	1,089	-49	$0	$0
	5/6/2007		1040	$50.31	83.77%	16.23%	871	169	$0	$0

Appendix C
Schedule of Stock Options

XYZ Price: $50.00

Date of Divorce 7/13/2006

Date Granted	Date Vested	Total Shs	Shares Vested	Strike Price	Comm. Percentage	Separate Percentage	Comm. Shares	Separate Shares	Community Value	Separate Value
7/22/2002		4,050	1,620	$32.25	100.00%	0.00%	1,620	0	$28,763	$0
	7/22/2005		810	$32.25	100.00%	0.00%	810	0	$14,382	$0
	7/22/2006		810	$32.25	99.43%	0.57%	805	5	$14,299	$82
	7/22/2007		810	$32.25	79.55%	20.45%	644	166	$11,441	$2,940
5/13/2003		5,600	2,240	$34.33	100.00%	0.00%	2,240	0	$35,101	$0
	5/31/2006		1,120	$34.33	103.92%	-3.92%	1,164	-44	$18,238	-$688
	5/31/2007		1,120	$34.33	78.27%	21.73%	877	243	$13,737	$3,813
	5/31/2008		1,120	$34.33	62.75%	37.25%	703	417	$11,012	$6,538
11/11/2003		2,250	450	$39.23	100.00%	0.00%	450	0	$4,849	$0
	11/11/2005		450	$39.23	133.47%	-33.47%	601	-151	$6,472	-$1,623
	11/11/2006		450	$39.23	89.02%	10.98%	401	49	$4,316	$532
	11/11/2007		450	$39.23	66.78%	33.22%	301	149	$3,238	$1,611
	11/11/2008		450	$39.23	53.40%	46.60%	240	210	$2,589	$2,259
5/11/2004		5,600	1,120	$46.43	100.00%	0.00%	1,120	0	$4,004	$0
	5/11/2006		1,120	$46.43	108.72%	-8.72%	1,218	-98	$4,353	-$349
	5/11/2007		1,120	$46.43	72.48%	27.52%	812	308	$2,902	$1,102
	5/11/2008		1,120	$46.43	54.32%	45.68%	608	512	$2,175	$1,829
	5/11/2009		1,120	$46.43	43.46%	56.54%	487	633	$1,740	$2,264

Appendix C
Schedule of Stock Options

XYZ Price: $50.00

Date of Divorce 7/13/2006

Date Granted	Date Vested	Total Shs	Shares Vested	Strike Price	Comm. Percentage	Separate Percentage	Comm. Shares	Separate Shares	Community Value	Separate Value
1/27/2005		3,300	0	$43.24						
	1/27/2006		660	$43.24	145.93%	-45.93%	963	-303	$6,511	-$2,049
	1/27/2007		660	$43.24	72.97%	27.03%	482	178	$3,255	$1,206
	1/27/2008		660	$43.24	48.64%	51.36%	321	339	$2,170	$2,291
	1/27/2009		660	$43.24	36.46%	63.54%	241	419	$1,627	$2,835
	1/27/2010		660	$43.24	29.17%	70.83%	193	467	$1,301	$3,160

	Comm. Shares---------------->	Sep.	Comm. Value-------------------->	Sep.
Totals	54,278	3,585	532,573	27,755
Grand Total		57,863		560,328

Governing Formula: (keys off number of days between dates)

Comm. Portion = Date of Vesting minus date of Divorce

Divided by: Date of Vesting minus Date of Grant