

# 10

## Stock Options and Benefits Under Executive Business Plans

Debra S. Frank

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## I. INTRODUCTION

### §10.1 A. Scope of Chapter

Specialized forms of compensation have long been used by corporations to attract and retain employees and, particularly, key executives. In addition, many private professional firms with a single, highly compensated employee, such as an owner-operator, or small group of highly compensated employees, such as attorneys, physicians, accountants, and architects, provide specialized executive benefits. Stock options have also been popular for “start-up” companies, particularly during the “dot-com” boom, to preserve the new companies’ cash and provide employees with an incentive to give their best efforts for the companies’ success.

This chapter discusses these specialized compensation programs, with a focus on stock options and benefits that usually, though not exclusively, are provided to highly compensated employees. It first describes stock options, which, although largely perceived as an executive-level fringe benefit, have increasingly been offered to nonexecutive employees, and explains the differences between qualified and nonqualified options, as well as summarizing related tax issues. The chapter also briefly summarizes features of other specialized benefits, including supplemental executive retirement plans (SERPs) and Rabbi Trusts.

### §10.2 B. Characterization of Benefits

An employee’s compensation in the form of stock options and other specialized benefits is community property to the extent the work done to earn them is performed during marriage and before the parties’ separation. Fam C §760; *Marriage of Frahm* (1996) 45 CA4th 536, 544. Such benefits are community property even if the options or other benefits cannot be exercised or received until after separation. However, the circumstances surrounding the grant of the benefit must be examined, particularly in the case of stock options, in order to determine the benefit’s separate, community, or mixed character. See generally *Marriage of Hug* (1984) 154 CA3d 780, 786 (finding that because purposes underlying stock options differ, reference to facts of each case must be made to reveal features and implications of particular option).

## II. STOCK OPTIONS

### A. Types of Stock Options and Their Taxation in General

#### 1. Types of Stock Options

##### §10.3 a. Background

Companies use stock options to help attract, retain, and compensate employees and, in some cases, nonemployees, such as board members. When a company grants stock options to an employee, it is giving the employee the option to buy stock now or in the future at a given price, also known as the “strike price.” See, e.g., *Varghese v Honeywell Int’l, Inc.* (4th Cir 2005) 424 F3d 411, 414 (defining “strike price” as fixed price at which owner of stock option can purchase underlying security); *Marriage of Perlstein* (2006) 137 CA4th 1361, 1374. This set price is typically the price of the stock on the day of the grant. Such options are intended to encourage greater employee commitment to the success of a company or to compensate them for low salaries in the case of a new business venture. Stock options can also serve as a means of tax-deferring compensation.

Employment-related stock options are generally classified as either “qualified” (also known as “statutory”) or “nonqualified,” depending on whether they are granted under, and governed by, specific Internal Revenue Code sections. Qualified options are governed by IRC §§421–424.

#### b. Qualified Stock Options

##### §10.4 (1) Overview

There are two types of qualified stock options, incentive stock options (ISOs) and options granted under employee stock purchase plans (ESPPs). The requirements for tax qualification of these stock option programs are described in IRC §§421–424.

In addition, the Corporations Code expressly authorizes stock purchase or option plans or agreements in California (Corp C §408(a)):

A corporation may adopt and carry out a stock purchase plan or agreement or stock option plan or agreement providing for the issue and sale for such consideration as may be fixed of its unissued shares, or of issued shares acquired or to be acquired, to one or more of the employees or directors of the corporation.

##### §10.5 (2) Incentive Stock Options

Statutory or incentive stock options (ISOs), as their name suggests, are granted as an incentive to employees to attract or retain them, to give them

a proprietary interest in the company, and to motivate them to devote their energies to the company. ISOs must meet strict statutory requirements, the most significant of which are the following (IRC §§421(c)(1)(A), 422(c)(6), (d)):

- They must be exercisable within 10 years of their grant (but there is a special 5-year rule for an individual who owns more than 10 percent of all voting classes of stock);
- They are nontransferable, but may pass by will or succession and be exercised by the deceased employee's representative;
- The strike (or option) price cannot be less than the fair market value of the stock on the date of grant (but can be 110 percent of fair market value for an individual who owns more than 10 percent of all voting classes of stock);
- The recipient of the option must remain an employee during the entire term of the option, but may exercise the option within 3 months following termination of employment and still remain eligible for ISO tax treatment;
- The 3-month posttermination exercise period is extended to 1 year for an employee whose termination of employment is due to disability, and it is waived entirely in the case of death; and
- There is a cap of \$100,000 on the aggregate fair market value of ISOs exercisable for the first time by any individual during any calendar year; to the extent the fair market value of ISOs exceed \$100,000, they will cease to qualify.

ISOs give employers great flexibility in designing their benefit packages because they are not limited by any discrimination rules in deciding who may receive them. For example, there is no requirement that the ISO be offered to all employees, only that the recipient be an employee during the entire term of the option (as specified immediately above). See Treas Reg §1.421-1(h).

### **§10.6 (3) Employee Stock Purchase Plans**

Employee stock purchase plans (ESPPs) are corporate plans that give employees the right to purchase stock in their company. A qualified ESPP, sometimes referred to as a “§423 Plan,” must meet the IRC §423 require-

ment that the plan be extended broadly to all employees. Section 423 also imposes limits on the exercise price and the term of options granted under the plan.

The sponsoring corporation may exclude certain employees from participation in a qualified ESPP. The permitted exclusions include certain part-time employees (defined as employees customarily employed fewer than 20 hours a week or for not more than 5 months in a calendar year), employees who have been employed for less than 2 years, and highly compensated employees, as defined in IRC §414(q) for tax-qualified plan purposes. IRC §423(b)(4)(A)–(B), (D); Treas Reg §1.423–2(e)(1).

As with ISOs, the plan must be approved by stockholders, and the acquired shares are subject to a postacquisition holding-period requirement if the full tax benefits are to be realized.

An important advantage for any ESPP is the ability to offer the employee the option to purchase the stock at a discounted price. The discount price can be up to 15 percent below the fair market value of the stock, determined either at the time of grant or at exercise. See IRC §423(b)(6). As long as the plan meets the tax-qualification requirements, employees will not recognize income when the stock is purchased, but instead will recognize income at a later time when the stock is sold or otherwise disposed of, subject to the time limits set forth by statute. IRC §423(a).

**Holding period.** The stock purchased may not be sold within 2 years from the date the option was granted or 1 year from the date it was exercised, whichever is later. An employee who leaves the company has 3 months to exercise the options. See IRC §423(a).

**Restrictions on transfers.** A qualified ESPP must prohibit the transfer of options issued under the plan, except for transfers by will or the laws of descent or distribution, and the option must be exercisable during the employee's lifetime only by the employee. IRC §423(b)(9); Treas Reg §1.423–2(j). These transfer restrictions are the same as for ISOs.

**NOTE** ► An ESPP should not be confused with an employee stock ownership plan (ESOP). An ESOP is a kind of tax-qualified defined contribution plan that invests the contributions in the employer's stock, and should be treated the same as any profit-sharing or other individual account plan.

### §10.7 c. Nonqualified Stock Options

A nonqualified (also called “nonstatutory”) stock option (NSO) is so named because it fails to comply with the requirements for “qualification” (*i.e.*, favorable tax treatment) as an ISO or option under an ESPP as provided by IRC §§422–424. See Rev Rul 2002–22, 2002–19 Int Rev Bull 849 (describing “nonstatutory” options).

Because they are not limited by the restrictions of the Internal Revenue Code, NSOs provide employers the flexibility to control the exercise price and determine the option term, vesting requirements, and posttermination exercise rights. The plans generally allow the employee to purchase shares at a fixed exercise price for a number of years, with varying vesting rules dependent on the plan. See, *e.g.*, *Marriage of Harrison* (1986) 179 CA3d 1216, 1224 (describing forfeiture rules of certain nonqualified options granted to employee, and distinguishing between vesting of options and vesting of restricted stock that employee might purchase by option). The following are some of the common ways in which NSOs differ from ISOs:

- NSOs may be granted to nonemployees. Outside directors, contractors, and other nonemployees may receive NSOs, but not ISOs.
- NSOs are not limited by the \$100,000 cap (IRC §422(d)) that applies to ISOs.
- NSOs may have an exercise price lower than the fair market value of the stock on the date of the grant—these are called discounted stock options.
- NSOs are not restricted to a 10-year expiration, although most companies do limit NSOs to 10 years or less.
- NSOs are not limited to any specific exercise period following termination of employment (if the recipient is an employee).

**NOTE►** Discounted stock options that do not comply with the requirements of IRC §409A (which provides specific rules for the tax treatment of nonqualified deferred compensation) and that are not “grandfathered” under former rules may subject the holder to severe tax penalties and interest.

## 2. Income Taxation of Stock Options in General

### a. Qualified Stock Options

#### §10.8 (1) Incentive Stock Options

Taxation of incentive stock options depends on when the option was granted or the stock option was exercised and when the stock is sold. In general, if the stock is sold at least 2 years after the date the option was granted or 1 year from the date it was exercised, whichever is later, gain from the sale will be taxed as capital gain. See IRC §422(c)(2). Otherwise, any gain is taxed as ordinary income. See Treas Reg §1.421–2(b). Gain also will be taxed as ordinary income if the option price of the stock was below the stock’s fair market value at the time the option was granted. See generally Treas Reg §1.422–1(e)(1).

The stock’s tax basis is what an employee paid for it plus the cost of the option, if anything. Usually, the *cost* of the option will be zero, in contrast to the option’s potential value. See *Xilinx Inc. & Subsidiaries* (2005) 125 TC 37, 45 (discussing valuation of employee stock options). Assuming that the above holding-period requirements have been met, taxable gain is the difference between the amount paid for the stock (the option price) and the amount received when the stock is sold. There are other measurements of gain if the holding-period requirements have not been met, or if the option price was below the fair market value of the stock when the option was granted. For examples of determining gain in various factual situations involving ISOs, see Treas Reg §§1.422–1—1.422–5.

These transactions are also potentially subject to an alternative minimum tax. See IRC §56(b)(3); IRS Letter Ruling 200519011. When the option is exercised, the alternative minimum tax is based on the difference between the price of the option (usually zero) and the market price of the stock when the option is exercised.

For the effect of a transfer between spouses or “incident to divorce” on the qualified status of an option, see Treas Reg §§1.421–1(b)(2), 1.424–1(c)(iv). See also Rev Rul 2002–22, 2002–19 Int Rev Bull 849 (noting that transfer of statutory stock options, *e.g.*, those under IRC §422 or IRC §423(b), contrary to their terms to spouse or former spouse on divorce would disqualify them as statutory options, resulting in same treatment as other nonstatutory stock options). On rules concerning the collection of Social Security tax (also known as tax under the Federal Insurance Contributions Act (FICA)) and federal unemployment tax (under the Federal

Unemployment Tax Act (FUTA)) in connection with a transfer of stock options on dissolution, see Rev Rul 2004–60, 2004–24 IRB 1051.

## §10.9 (2) Employee Stock Purchase Plan

In general, the tax rules applicable to the sale of stock purchased through the exercise of options granted under an employee stock purchase plan follow the rules for incentive stock options (see §10.8), including the holding-period requirements. Gain from such a sale is generally treated as capital gain. See Treas Reg §1.423–1(a).

**Option granted at discount.** A special rule applies if the option price per share was less than 100 percent (but not less than 85 percent) of the fair market value of the share when the option was granted. In that case, assuming the stock was disposed of after meeting the holding-period requirements, the gain may be taxed as ordinary income up to a certain level. Treas Reg §1.423–2(k). The income is calculated as the *lesser* of the following (Treas Reg §1.423–2(k)):

- The amount, if any, by which the price paid under the option was exceeded by the share’s fair market value at the time the option was granted; or
- The amount, if any, by which the price paid under the option was exceeded by the share’s fair market value at the time the share was disposed of (*e.g.*, sold).

In making this determination, if the option price was not fixed or determinable at the time the option was granted, the option price is calculated as if the option had been exercised when it was granted. Treas Reg §1.423–2(k). Any excess gain is treated as a capital gain. See IRC §423(c).

Coordination with qualified equity grants. An option for which an election is made under IRC §83(i) with respect to the stock received in connection with its exercise may not be considered as granted under an employee stock purchase plan. IRC §423(d).

## §10.10 b. Nonqualified Stock Options

How a nonqualified stock option is taxed depends on whether it has a readily ascertainable fair market value at the time it is granted. If there is no such fair market value at that time, the grant is a nontaxable event, although the exercise of such options does constitute a taxable event. See generally IRS Letter Ruling 200519011.



If the option has a readily ascertainable fair market value, it is taxed at ordinary income tax rates when it is granted, on the basis of the difference between the fair market value and the cost of the option to the employee. See IRC §83(a); IRS Letter Ruling 200519011. See also Treas Reg §1.421-2(b)(1)(ii) (examples of disqualifying dispositions).

If the fair market value of the option is not readily ascertainable, the employee is taxed when the option is exercised or otherwise transferred. The basis is the fair market value of the option on which taxes were paid plus the amount paid for the option. Any subsequent taxes paid are at capital gains rates. The holding period for the computation of capital gains rates begins to run when the option is exercised, not when it is granted. See generally IRS Letter Ruling 200519011. Thus, many employees prefer to exercise the stock option early to start the capital gains holding period running.

A readily ascertainable fair market value exists if the option itself is actively traded on an established market or in the unusual situation when the option has a measurable fair market value that can be determined with reasonable certainty. Treas Reg §1.83-7(b). Unless the option is traded in an established market, a measurable fair market value requires that the option be transferable, that it be immediately exercisable in full, and that it not be subject to any restriction significantly affecting its fair market value. Treas Reg §1.83-7(b). Furthermore, even if there is an identifiable market or a measurable fair market value under the above criteria, there is no tax on the grant unless it is transferable and not subject to a substantial risk of forfeiture. Treas Reg §1.83-7(a).

If the grant is not a taxable event under the criteria set forth above, the taxable event is the exercise of the option. The tax is based on the difference between the fair market value of the shares and the option price, if any. However, if the stock received is subject to a substantial risk of forfeiture, such as when the employee receives restricted stock, there is no recognized income from the exercise while the shares are subject to such a risk of forfeiture. Treas Reg §1.83-7(a).

The Tax Cuts and Jobs Act added new IRC §83(i) of the Internal Revenue Code which permits qualified employees of eligible private corporations to make an §83(i) election to obtain favorable tax treatment for qualified equity grants. Employees may elect to pay income taxes at the time of the grant of the stock and pay any subsequent stock appreciation at capital gains rates. See Pub L 115-97, §13603(a), 131 Stat 2159.

## B. Dividing and Valuing Stock Options on Marital Dissolution

### §10.11 1. Apportioning Community and Separate Interests

Stock options constitute community property to the extent they are attributable to services rendered during marriage and before the parties' separation, even if the options are exercisable at a later time. *Marriage of Nelson* (1986) 177 CA3d 150, 153; *Marriage of Hug* (1984) 154 CA3d 780, 786. To properly apportion separate and community interests in stock options, it is necessary to ascertain the periods of employment to which the options may properly be allocated. This requires an examination of the circumstances of the option grants to determine whether the options should be characterized as deferred compensation, incentives for future performance, or both. *Marriage of Hug* (1984) 154 CA3d 780, 786. See *Marriage of Lehman* (1998) 18 C4th 169, 188 (community property includes retirement benefits accrued by employee as deferred compensation regardless of whether such rights are vested or matured at time of separation); *Marriage of Harrison* (1986) 179 CA3d 1216, 1227. But see *Marriage of Frahm* (1996) 45 CA4th 536, 544 (casting doubt on use of past-versus-future-services analysis to determine characterization of employee benefit).

In apportioning community and separate property interests in stock options, there are no fixed rules, and the trial court has broad discretion to adopt any equitable method of apportionment after examining the facts and evaluating the nature of the option. *Marriage of Nelson*, 177 CA3d at 154; *Marriage of Hug*, 154 CA3d at 792. One method of apportioning stock options is by the so-called "time rule." See *Marriage of Brown* (1976) 15 C3d 838, 842. Under the "time rule," the community interest in the benefit generally is measured by means of a fraction, the numerator of which represents the length of service during the marriage and before separation (needed to earn the benefit) and the denominator of which represents the total length of service by the employee spouse. *Marriage of Lehman*, 18 C4th at 187; *Marriage of Henkle* (1987) 189 CA3d 97, 99. See *Marriage of Steinberger* (2001) 91 CA4th 1449, 1459 (applying time rule, but finding some options community and others wife's separate property on basis of employer's severance arrangement).

**Options granted before separation.** In the seminal *Hug* case, an appellate court upheld a trial court's implied finding that the options at issue (referred to as "intermediate" because they were not exercisable until

after separation though granted before then) were primarily deferred compensation earned from the onset of employment. It affirmed the use of the following time-rule calculation: The number of options determined to be community property is a product of a fraction in which the numerator is the period in months between the commencement of the spouse's employment by the employer and the date of the parties' separation, and the denominator is the period in months between commencement of employment and the date when each option is first exercisable, multiplied by the number of shares that could be purchased on the date the option is first exercisable. The remaining options are the separate property of the employee. *Marriage of Hug*, 154 CA3d at 782, 789.

A variation in the time-rule formulation was applied in *Marriage of Nelson* (1986) 177 CA3d 150, 155 n3. Under *Nelson*, the community interest in an intermediate option is the ratio that the time worked between the date of the grant and the date of separation bears to the time worked



between the date of the grant and the date the option is first exercisable. 177 CA3d at 155. Accordingly, the numerator of the time-rule fraction in that case was the number of months from the date of each grant of block of options to the date of separation, and the denominator was the period of time from each grant to the date of exercisability. Whereas the *Hug* court viewed the stock options at issue as primarily deferred compensation, and adopted a formula that recognized work performed from the onset of employment, the *Nelson* court viewed the options as primarily future incentives (rather than for past service) and, accordingly, adopted a formula that recognized only work performed from the granting of the options. See 177 CA3d at 155 n3 (noting that emphasis on period following each grant was appropriate because only prospective increases in value of stock could result in profit to option holders).

When intermediate stock options are found to be “golden handcuffs,” designed to ensure that an employee will remain with an employer, they are primarily future incentives (as in *Nelson*) rather than deferred compensation (as in *Hug*). *Marriage of Harrison* (1986) 179 CA3d 1216, 1227. Thus, in *Harrison*, the court followed *Nelson* in attributing options to work performed from the date the options were granted, rather than from the date employment commenced. *Marriage of Harrison, supra*. The community interest in an option under *Harrison* is the ratio that the time worked between the granting of the option and the date of separation bears to the time worked between the granting of the option and the date on which the stock is vested and not subject to divestment. Specifically, under *Harrison*, the time-rule fraction consisted of a numerator that was the total number of days between the granting of the option and the date of separation, and a denominator that was the total number of days between the granting of the option and the date on which each portion of the option became fully vested and not subject to divestment. The ratio created by that fraction then was to be divided into the gain on the stock option on the date of exercise to determine the community property interest (after reimbursement for the purchase of the option and any taxes paid by the option grantee in connection with the exercise of the option). All remaining interest was the separate property of the option grantee. 179 CA3d at 1223 n1, 1225. Note that the period expressed in the denominator of the fraction runs to the date the stock is vested, rather than to the date the option is exercisable, as in *Nelson*. The distinction occurs because, under the “nonqualified” options in *Harrison*, the stock can be purchased on the day the option is granted, but it will be subject to divestment if the employee is terminated for cause or leaves voluntarily without the employer’s consent before specified dates.

For a case applying the *Harrison* formula and discussing *Hug* and *Nelson*, see *Marriage of Walker* (1989) 216 CA3d 644, 650 (trial court abused discretion in not applying *Harrison* formula).

**Options granted after separation.** The *Nelson* court also addressed options granted *after* separation and affirmed a ruling that they were entirely the separate property of the employee spouse, noting that the employee had no expectation of the grant and could profit only if the stock value rose after the date of the grant. *Marriage of Nelson* (1986) 177 CA3d 150, 157. It might be argued that a stock option granted after separation that is found to be in part deferred compensation for work performed *before* separation will be apportioned between community and separate property interests. See *Marriage of Steinberger* (2001) 91 CA4th 1449, 1459 (applying time rule, but finding some options community and others wife’s separate property on basis of employer’s severance arrangement). However, as with other deferred compensation, the right to the option must arise during marriage and before the parties’ separation to be characterized as community property. See *Marriage of Lehman* (1998) 18 C4th 169, 183 (citing with approval *Frahm* analysis of characterizing deferred compensation). Further, a claim of a community interest in a stock option granted after *dissolution* appears to be too speculative for exercise of jurisdiction over it. *Marriage of Hug* (1984) 154 CA3d 780, 793 n4.

## §10.12 2. Valuation

In general, stock options are valued as of the date of trial. Fam C §2552(a); *Marriage of Reuling* (1994) 23 CA4th 1428.

The value of stock options is a question of fact depending on the differential between the option price and value of the stock. Valuation of the stock turns on a variety of factors, including any restrictions placed on the stock subject to the option. In one case, for example, the court utilized a host of factors in valuing stock, derived from an IRS Revenue Ruling (*Marriage of Micalizio* (1988) 199 CA3d 662 (using Rev Rul 59–60, 1959–1 Cum Bull 237)):

- Nature of the business and history of the enterprise from its inception;
- Economic outlook;
- Book value of the stock;
- Financial condition of the business;
- Earning capacity of the company;

- Dividend-paying capacity;
- Existence of goodwill or other intangible value;
- Sales of stock;
- Size of the stock block to be valued; and
- Market price of stocks of corporations engaged in the same business or similar line that are actively traded in a free and open market, either in an exchange or over the counter.

Courts have also noted the possibility of other valuation methods. See, *e.g.*, *Xilinx Inc. & Subsidiaries* (2005) 125 TC 37, 45 (discussing valuation of employee stock options using accounting standards, *e.g.*, “fair value method,” which uses pricing models such as “Black Scholes”).

**PRACTICE TIP** ► Because of the uncertainties associated with stock option valuations, counsel should seek to have options divided in kind whenever feasible.

### §10.13 3. Related Tax Issues

In general, tax consequences are not to be considered in valuing community property unless they are “immediate and specific.” See *Marriage of Fonstein* (1976) 17 C3d 738, 748 (tax consequences generally ignored by court unless “immediate and specific”); *Marriage of Nelson* (1986) 177 CA3d 150, 156.

However, if stock options cannot be assigned, and therefore cannot be divided in kind, it *may* be proper to take tax consequences into consideration in the valuation process. See *Marriage of Harrison* (1986) 179 CA3d 1216, 1227 (options were *almost certain* to be exercised and tax consequences were *predictable*). One court has affirmed a credit against potential tax liability resulting from the exercise of stock options awarded as part of the property division, even though the credit did not meet the “immediate and specific” test. It based its reasoning on former CC §4800(b)(1) (predecessor of Fam C §2601—when economic circumstances warrant, court may award asset to one party on such conditions as it deems proper to effect substantially equal property division). The economic circumstance cited was that because the options were nonassignable and therefore had to be awarded to the employee spouse, the more equitable distribution, *i.e.*, to divide in kind and leave each party at the mercy of his or her own tax circumstances, was not available. *Marriage of Nelson* (1986) 177 CA3d 150, 156. *Nelson* appears to give some support to

creative efforts to achieve court consideration of tax consequences even when the “immediate and specific” test is not met.

### **§10.14 C. Stock Options as Income for Support**

Stock options have been held to constitute income for support purposes when they represent an element of a supporting party’s compensation package for past, present, or anticipated future services. *Marriage of Cheriton* (2001) 92 CA4th 269, 286 (income is realized at very latest when stock option is sold for gain but may also be realized on exercise of option); *Marriage of Kerr* (1999) 77 CA4th 87, 96.

By contrast, the market value of unsold shares of *stock* received by a business owner in connection with the sale of a business is generally not income for support purposes. Unlike stock options that are paid as compensation for past, present, or anticipated future services, unliquidated stock received as part of the sale of a capital asset is indistinguishable from other types of nonliquid assets that are not normally considered income for support purposes. *Marriage of Perlstein* (2006) 137 CA4th 1361, 1372.

For related discussion of this topic, see Practice Under the California Family Code: Dissolution, Legal Separation, Nullity, chaps 6, 8 (Cal CEB).

## **III. EXECUTIVE BENEFITS**

### **§10.15 A. Analyzing Benefits Under Executive Compensation Plans**

Employee benefits provided to executives and highly compensated non-executives within a company may take numerous forms and may or may not be deemed “qualified” under the Internal Revenue Code. Even if the benefit is provided under a nonqualified plan, it may still be subject to ERISA’s reporting, disclosure, administration, and enforcement provisions.

A number of typical executive benefits are provided under nonqualified plans, and therefore the discussion hereafter focuses on these.

**Company mergers.** An issue that counsel should keep in mind in assessing the nature of an executive benefit is the effect of company mergers on the original plan that provided the benefit. Any successor plan must be examined to determine whether benefits under the original plan survived the merger, were exchanged for or combined with new benefits, or were simply extinguished. Because nonqualified plans are usually



unfunded and



never protected by insurance through the federal Pension Benefit Guaranty Corporation (PBGC), there is also a risk to both spouses if the company becomes insolvent.

**EXAMPLE►** For an illustration of how a merger resulted in the frustration of a plan participant’s expectations and an apparent windfall to his former wife, see *Moore v Raytheon Corp.* (ND Tex 2004) 314 F Supp 2d 658. In *Moore*, an employee participated in several qualified and nonqualified plans, with the nonqualified plans intended to provide retirement benefits that could not be provided under the qualified-plan formula, because of IRC §415 benefit limitations. In 1997, the plans were transferred to a new employer as the result of a merger. A qualified domestic relations order (QDRO) entered in the employee’s California dissolution assigned the wife an interest in one of the qualified plans and *none* in the *nonqualified* plans. In April 2000, the new employer amended the qualified plan to take advantage of an increase in the maximum permissible level of benefits, which caused a corresponding reduction in the benefits provided under the nonqualified excess benefit plan. As a result, the former spouse became entitled to money that she would not have received had they been provided under the nonqualified plan. In a suit by the employee to recalculate benefits under the QDRO (and for other relief), the court rejected his claim on the ground that the plan was amended in accordance with a change in the law and published IRS guidance. Although he was dissatisfied with the result, there was no authority requiring the employer or plan to bear the burden of amending the original QDRO to his satisfaction. 314 F Supp 2d at 664.

## B. Nonqualified Deferred Compensation Plans

### 1. Overview and Tax Issues

#### §10.16 a. Overview

Deferred compensation through a nonqualified plan is usually funded through company contributions and is designed to allow select employees to exceed the Internal Revenue Code’s limitations on “retirement compensation” that otherwise may be paid from a qualified plan. See IRC §401(a). In addition, these plans sometimes allow for salary deferrals, thereby permitting employees to defer compensation (in addition to the amount that

might be deferred under an IRC §401(k) plan) without regard to the limits under the Internal Revenue Code. Nonqualified plans may take the form of either defined benefit or defined contribution plans.

Funds within a participant’s account are intended to be used on retirement, but many plans permit an earlier withdrawal by means of an advance election, subject to certain conditions. Some plans, however, impose a penalty on withdrawals before retirement.

The following are examples of nonqualified arrangements that provide deferred pay:

- Annual bonus awards (in which a bonus is deferred);
- Individual contractual arrangements for deferred compensation with one or more employees (or outside directors); and
- Phantom stock arrangements that provide employees with benefits based on the appreciation of company stock without granting ownership rights in the company.

Some nonqualified plans are referred to as “top hat” plans because they are used to provide deferred compensation for a select group of top management or otherwise highly compensated employees. See, *e.g.*, 29 USC §1051(2) (excluding such plans from ERISA participation and vesting statutes). Nonqualified plans are essentially unilateral contracts for the payment of deferred compensation and are generally unfunded, *i.e.*, no funds are set aside for the payment of benefits into a separate trust that is protected from the employer’s creditors, and they are not eligible for the insurance protection provided by the PBGC. The most well-known of these plans are supplemental executive retirement plans (SERPs), which are discussed in §10.18.

Although a judgment in a marital dissolution proceeding may award a community interest in benefits under a nonqualified plan to the nonemployee spouse, federal law has not clarified whether QDRO status is required for a state law award of benefits to be enforceable in the face of ERISA’s broad preemption provisions. Although many of the tax issues have been resolved (see Rev Rul 2002–22), some matters remain unclear. The IRS has provided some limited guidance in one private letter ruling, in which it concluded the following (IRS Letter Ruling 200442003):

- A stipulated, postdissolution transfer to a former wife of a lump sum constituting her (awarded) share of her former husband’s nonqualified plan before his retirement was a transfer “incident to divorce” and thus subject to IRC §1041;

- The assignment-of-income doctrine did not apply; and
- The transfer was for adequate consideration, and thus not subject to gift tax.

Although such a ruling cannot be cited as precedent (IRC §6110(k)(3)), it may be useful as guidance in similar circumstances.

**PRACTICE TIP**► At least one federal district court has concluded, in an *unpublished* opinion, that although “top hat” plans are subject to ERISA’s reporting, disclosure, administration, and enforcement provisions, “[t]he dominant characteristic of the ‘top hat’ regime is the near-complete exemption from ERISA’s substantive requirements, including the minimum participation standards, minimum vesting standards, and various other content requirements.” On the basis of this conclusion, it held that such a plan is also exempt from the requirement (applicable to a qualified plan) that benefits be paid to a surviving spouse. *Boulet v Fluor Corp.* (SD Tex, Oct. 31, 2005, No. H-05-0105) 2005 US Dist Lexis 29973. See 29 USC §§1021–1031, 1051(2). This reasoning makes it possible that a nonqualified plan sponsor may decline to recognize a nonemployee’s interest that is awarded by a QDRO, particularly if the plan includes an antialienation clause, because the statutory QDRO provisions do not apply to “top hat” plans. On the other hand, if the plan is exempt from the QDRO provisions, it is also exempt from ERISA’s antialienation provisions (of which the QDRO provisions are a part). ERISA §§4(b)(5), 201(2) (29 USC §§1003(b)(5), 1051(2)). In the event of a plan’s uncooperative behavior with regard to discovery and disposition of a nonqualified plan, counsel may wish to consult an attorney who specializes in ERISA.

### §10.17      b. Tax Issues Concerning Division of Nonqualified Executive Benefits

A nonqualified plan that provides for executive benefits does not satisfy the rules of IRC §401(a)(3)–(4). As a result, the tax benefits available to employers and employees under the tax-qualified plan rules are not available in a nonqualified arrangement.

To the extent that any of the assets comprising the nonqualified plan have been acquired with posttax funds, the tax consequences should be considered—at least for negotiation purposes, even though the consequences are not recognized by a court as being “immediate and

specific”—in determining the proper division of the benefits. Counsel should consider consulting qualified tax counsel in this regard.

**Importance of IRC §409A.** The American Jobs Creation Act of 2004 (Pub L 108–357, 118 Stat 1418) added IRC §409A, which provides specific rules governing the tax treatment of nonqualified deferred compensation. Before the enactment of this section, there were no specific rules governing this type of compensation, and a variety of general tax principles applied. Under §409A, unless certain requirements are satisfied, amounts deferred under a nonqualified deferred compensation plan will be includable in current income to the extent these amounts are not subject to a “substantial risk of forfeiture.” See IRC §409A(a)(1), (d)(4). Section 409A also affects the way that such plans are structured. See generally Joint Congressional Committee on Taxation, Present Law and Background Relating to Executive Compensation, JCX–39–06, at 10 (2006). Section 409A includes, for example, provisions governing constructive receipt of benefits, funding, initial elections to defer compensation, limitations on distributions under a plan and acceleration of plan benefits, and elections to change the time or form of benefit. See IRC §409A(a)–(c). Section 409A is generally effective with respect to amounts deferred after December 31, 2004. Pub L 108–357, §885(d), 118 Stat 1418.

The Tax Cuts and Jobs Act added new IRC §409A(d)(7) regarding the treatment of qualified stock, stating that an arrangement under which an employee may receive qualified stock (as defined in IRC §83(i)(2)) “shall not be treated as a nonqualified deferred compensation plan with respect to such employee solely because of such employee’s election, or ability to make an election, to defer recognition of income under section 83(i).” See Pub L 115–97, §13603(c)(2), 131 Stat 2164.

A full discussion of §409A is beyond the scope of this chapter. Counsel in a family law matter should seek the assistance of a qualified tax professional in assessing the effect of §409A on the compensation arrangement involved in a particular case.

## §10.18      2. Supplemental Executive Retirement Plans (SERPs)

Supplemental executive retirement plans (SERPs) are usually “unfunded” (*i.e.*, entirely paid out of the employer’s general assets) and can take the form of a defined benefit plan or a defined contribution plan. They typically are nonqualified, deferred compensation retirement plans designed to provide benefits for a group of executives in addition to benefits that are provided under a qualified retirement plan.

**§10.19      3. “Rabbi Trusts”**

“Rabbi trusts,” so named after an IRS Letter Ruling involving a rabbi that first addressed such entities, are another form of nonqualified executive compensation arrangement. See IRS Letter Ruling 8113107 (involv-





ing trust for rabbi's benefit, in 1980). A rabbi trust is a type of grantor trust in which an employer may set aside money to finance a nonqualified plan without causing the plan to be considered "funded" and thereby triggering an immediate tax. By making the entity a grantor trust, the assets are available to creditors at all times even though the assets may not be used for day-to-day corporate expenses.

The employer is treated as the owner of the rabbi trust and is taxed on its income, as long as the executive's right to receive money from the trust is "subject to substantial limitations or restrictions," rather than being the executive's to draw on at any time. *Bank of America v Moglia* (7th Cir 2003) 330 F3d 942, 944 (in personal bankruptcy proceeding, clause in rabbi trust agreement prohibiting settlor from granting creditors security interest in trust corpus held enforceable; impliedly, only unsecured creditors might reach corpus of rabbi trust). Note that private letter rulings may not be used or cited as precedent (IRC §6110(k)(3)), but may be useful to counsel as general guidance.

**NOTE►** The *Bank of America* court noted that the word "creditors" is not defined either in the IRS's letter ruling (see IRS Letter Ruling 8113107) or in the trust agreement in this original rabbi case, but pointed out that the "Model Rabbi Trust" agreement approved by the IRS and provided at Rev Proc 92-64, 1992-2 Cum Bull 422, states that the assets of the trust are subject to the claims of the settlor's "general creditors," a term invariably used to refer to a debtor's unsecured creditors. *Bank of America*, 330 F3d at 946.

An employer's contributions to the rabbi trust are not currently taxable to the employee if the assets of the trust are subject to the claims of the employer's creditors in case of insolvency or bankruptcy. Rabbi trusts may be used to ensure many different kinds of deferred compensation. An employee may have "golden parachute" benefits held in a rabbi trust. The IRS provides model language for rabbi trusts, as well as procedures for obtaining advanced rulings about them. See Rev Proc 92-64, 1992-2, 2 Cum Bull 422. See also Notice 2000-56, 2000-43 Int Rev Bull 393.

### §10.20 C. Internal Revenue Code §457 Plans

Internal Revenue Code §457 plans are deferred compensation plans that are available to certain state and local governments and nongovernmental entities that are tax exempt under IRC §501. However, they do not include churches. IRC §457(e)(13). Most §457 plans are funded by employers.

The American Jobs Creation Act, enacted in 2004, affected §457 plans. Under that act, if a §457(f) plan involves employee deferrals of compensation, the election to defer must be made before the beginning of the year in which the services are performed giving rise to the compensation. Elections to defer “performance pay” (such as bonuses) must be made at least 6 months before the end of the performance period. See IRC §409A(a)(4).

**NOTE►** In general, a §457(f) plan is one that does not meet the requirements for qualification as a deferred compensation plan “eligible” for special tax treatment under IRC §457(b).

For related discussion of §457 plans, see §13.28.