The Universe of Executive Compensation

For the most part, executive compensation is deferred compensation. The purpose of deferred compensation is to defer the tax consequences of receiving compensation. The purpose of executive compensation is to compensate executives and highly compensated directors and employees in a manner that defers tax liability. This is achieved through various compensation mechanisms, each with unique structures. The universe of executive compensation may include:

- Stock options
- Restricted stock
- Phantom stock
- Stock appreciation rights
- Long-term incentive plans
- Short-term incentive plans
- Top hat plans
- Cash bonuses
- Severance payments
- Expense reimbursements
- Supplemental executive retirement plans
Before describing these various forms of executive compensation, it is important to have a framework to understand what executive compensation is, why it matters, and how it has evolved over time.

§ 2.1 QUALIFIED VERSUS NON-QUALIFIED BENEFITS

When describing executive compensation, it may be useful to start with a description of what it is not. Executive compensation is not qualified deferred compensation. When discussing “qualified” deferred compensation plans, we are referring to plans that are qualified for tax deferral under Section 401(a) of the Internal Revenue Code. These plans include things like traditional pension arrangements, 401(k) plans, thrift savings plans, money purchase pension plans, 403(b) plans, and the like. The hallmark of a qualified plan is that it is a funded plan that provides benefits to all employees (both the rank and file as well as the highly compensated) of a given employer subject to certain eligibility requirements, and subject to certain nondiscrimination requirements that help to ensure that highly compensated employees do not contribute to, or receive, an unfair percentage of the benefits under the plan.

A “funded” plan is one where the money used to pay the benefits is held in trust and is not subject to the claims of the plan sponsor’s creditors. In the case of a defined contribution plan, the employee and employer contributions are held in specific employee accounts. In a defined benefit plan, the trust holds the employer contributions that will be used to fund the retirement benefit that is promised under the plan. An “unfunded” plan is one where the money used to pay the benefits comes from the general assets of the company and is subject to the claims of the company’s creditors.

The assets of a non-qualified plan may be held in a special trust known as a “rabbi” trust. In a rabbi trust, even though the money is segregated from the general assets of the company, it is still subject to the claims of the company’s creditors.¹

Qualified plans are usually subject to the requirements of the Employee Retirement Income Security Act of 1974, as amended (“ERISA”).² However, there are some qualified plans, for example, government and church plans, that are not subject to ERISA.³

While executives may participate in qualified plans, subject to certain limitations, the term “executive compensation” is used to refer to non-qualified deferred compensation. The tax deferral characteristics of non-qualified deferred compensation stem from various provisions of the Internal Revenue
Code and case law. Just to confuse matters, while most non-qualified deferred compensation plans are not subject to ERISA, there are some instances, such as top hat plans, where certain provisions of ERISA will apply.\(^4\)

§ 2.2  **WHO IS AN “EXECUTIVE”?**

In general, an “executive” may include officers, directors, or a select group of management or highly compensated employees. In the case of a top hat plan, case law suggests that the requirement may be met “if there exists a noticeable disparity between the salaries of top hat plan participants and other employees.”\(^5\) In addition, there is case law indicating that a plan representing 16% or less of the total workforce is a non-qualified plan.\(^6\)

The reason that executive compensation plans are not subject to ERISA—or in the case of top hat plans, are exempted from the fiduciary and funding requirements of ERISA—is because they exist to defer taxes only for certain employees who have the power within the organization. Thus, they do not require the same scrutiny and protections as qualified plans where the main purpose is to provide benefits for rank-and-file employees.\(^7\)

§ 2.3  **THE HISTORY OF EXECUTIVE COMPENSATION**

For a family law practitioner to have an understanding of how executive compensation works, it may also be helpful to have a brief history of executive compensation, how executive compensation has evolved over time, and why executive compensation is what it is today.

Internal Revenue Code Section 83 provides the groundwork for taxing property transferred in exchange for the performance of services. In the simplest terms, this section of the Code provides that an employee will be taxed when property transferred for the performance of services vests. Vesting occurs on the first to occur of the date there is no longer a substantial risk that the property will be forfeited, or upon the date that the employee can transfer the property.

In 2000, the Enron Corporation paid its executives $432 million in bonuses for hitting certain stock-price targets shortly before the company went bust.\(^8\) Investigators concluded that during this time the company’s executives had inflated Enron’s profits by as much as $1 billion. The lasting effect of the Enron executives’ actions was profound. While executives of the company had accelerated their own executive compensation, Enron’s
more than 4,000 former employees lost their retirement benefits because the employees’ qualified retirement plan permitted employees to purchase stock in the company. When the company’s stock price plummeted in the wake of the Enron scandal, the rank-and-file employees were left with nothing. Partially in response to the Enron collapse, Congress passed several pieces of legislation that changed the face of executive compensation.

The Sarbanes-Oxley Act of 2002 (“SOX”) set out a comprehensive regulatory scheme with robust standards for public accounting firms, corporate executives, corporate managers, and boards of directors. Many provisions of SOX apply even to privately held companies. After Enron’s crash and the enactment of SOX, issuing executive compensation in the form of stock options was less appealing in the new regulatory state, mostly because companies were required to expense the cost of issuing stock options. In response, companies moved toward awarding more restricted stock in executive compensation. For example, from 2001 to 2011, the use of traditional stock grants increased from 8% of total pay to 36%. Many smaller perks of executive compensation packages have decreased or been eliminated. In 2006, for example, the median value of corporate reimbursements to executives fell by more than 40% in just one year. These benefits included use of corporate jets, company cars, personal financial counseling, and professional membership dues.

In addition, the demise of Enron led to the enactment of Code Section 409A, a series of comprehensive rules on the acceleration of deferred compensation meant to eliminate executives’ ability to pay themselves out except under certain limited circumstances. In a certain sense, this provision of the Code took away executives’ ability to manipulate vesting, an issue that had always been inherent in executive compensation arrangements as it has traditionally been the executives who have had the power to amend or terminate such arrangements in order to benefit themselves.

It is within the framework of Code Section 83 and Code Section 409A that family law attorneys must have some knowledge in order to properly divide executive compensation without unnecessarily triggering taxes and penalties for their clients.

§ 2.4 SUBSTANTIAL RISK OF FORFEITURE

As noted above, a substantial risk of forfeiture exists when a person’s right to deferred compensation is subject to future performance, satisfaction, or the occurrence or non-occurrence of a certain identifiable event. This standard is
The basis of the differentiation of deferred compensation as either “vested” or “unvested.” Deferred compensation is considered vested once it is no longer subject to a substantial risk of forfeiture. If deferred compensation is still subject to a substantial risk of forfeiture, it is said to be unvested.

Under Section 83(c) of the Internal Revenue Code, property that is transferred in connection with the performance of services is taxable to the recipient if that property may be transferred by the recipient or if it is no longer subject to a substantial risk of forfeiture. The rights of a person in property are subject to a substantial risk of forfeiture if such person’s right to full enjoyment of such property is conditioned upon the future performance of substantial services. Determining whether there is a substantial risk of forfeiture requires a court to determine the chances the employee will lose his or her rights in property transferred by the employer. Case law is very extensive regarding how this determination is made and when it applies.

For instance, the mere risk that property may decline in value during a period of time does not constitute a substantial risk of forfeiture. Further, a nonlapse restriction (a permanent restriction on the transferability of the property), standing by itself, will not result in a substantial risk of forfeiture.

The substantial risk of forfeiture is relevant to determining tax liability. For example, in Rev. Rul. 79-305, the Internal Revenue Service reviewed a transaction where a corporation transferred common stock to an employee subject to a substantial risk of forfeiture. Once the risk lapsed and the stock was vested, the fair market value of the stock at the time that the risk lapsed was considered part of the employee’s gross income for tax purposes. The following examples better illustrate the substantial risk of forfeiture and its impact on tax liability.

**Example 1:** Joy received 100 shares of Company A common stock in 2018. The stock was subject to a substantial risk of forfeiture, namely that Joy must remain employed with the company until January 2021 for the stock to vest, and the stock cannot be transferred to another person. In 2018 when Joy receives this benefit, it is subject to a substantial risk of forfeiture. That risk of forfeiture will lapse in 2021, assuming that Joy is still employed with the company at that time. If the fair market value of the stock in January 2021 is $100 per share, Joy must declare $10,000 of gross income in 2021 from this benefit when the stock vests.

**Example 2:** John received 100 shares of Company B common stock in 2018. The stock was subject to a substantial risk of forfeiture,
namely John must remain employed with the company until January 2021 for the stock to vest, and the stock cannot be transferred to another person. In 2021 when John receives this benefit, it is subject to a substantial risk of forfeiture. John quits his job at Company B in 2019. The 100 shares of Company B stock never vest and therefore, John does not receive the shares and does not incur any tax liability.

I will discuss in greater detail how the risk of forfeiture is relevant to executive compensation in divorce in later chapters. Specifically, I will discuss how to determine when a benefit becomes property versus a mere expectancy in Chapter 4.

§ 2.5 INTERNAL REVENUE CODE SECTION 409A

Code Section 409A places restrictions on the misuse of executive compensation by including the value of all compensation deferred under a given non-qualified deferred compensation arrangement in the gross income of the plan participant in the event of certain plan failures, unauthorized accelerations, improper distributions, and improper deferral elections.

Essentially, if the terms of a non-qualified deferred compensation plan do not meet the requirements set forth in Code Section 409A, or if the plan is not operated in accordance with those requirements, all compensation deferred under the plan for all participants for the taxable year and all preceding taxable years will be included in gross income for the current taxable year to the extent not otherwise subject to a substantial risk of forfeiture and not previously included in gross income. In addition to inclusion of all deferred compensation in the gross income of the participants in the year of the violation, there are also taxes and penalties due with respect to a violation of this provision. The statute does allow for plans to accelerate some distributions upon the occurrence of a separation from service, death, disability, fixed time, unforeseeable emergency, and change in control. The regulations under Code Section 409A permit plans to make early distributions in the event of divorce pursuant to a domestic relations order. However, this option exists only if the plan has a provision permitting it, and many plans do not have such provisions. As a result, family law practitioners must be aware of the draconian financial consequences that may occur if they attempt to force distribution of benefits from a plan that is subject to Code Section 409A.
§ 2.6 FORMS OF EXECUTIVE COMPENSATION

While your clients, or their spouses, may enjoy the benefits of executive compensation, they often do not understand the way they are compensated or how exactly their executive compensation works. As you have probably gathered from the Introduction, the statutory schemes that govern executive compensation are complex, onerous, and difficult even for the people receiving them to fully comprehend. In divorce, however, all marital assets must be divided. Further, the income received from executive compensation plans may also be included in income for support purposes. Thus, it becomes imperative that attorneys understand their clients’ compensation and benefits. The following discussion is only a primer to understand these forms of executive compensation. Future chapters will discuss these deferred compensation arrangements further and the issues to consider when dividing them as assets or when calculating income for support.

§ 2.6.1 Stock Options

A stock option is a contractual right to purchase stock in a company during a specified period and for a predetermined price. When a stock option is used to purchase stock, the option is said to have been “exercised.” The price at which the stock is purchased is called the “exercise price.” The “spread” is the difference between the grant price and the market value of the stock at the time the stock option is exercised. Options are “underwater” when the current price of the stock is less than the strike price. Most stock options have what is known as an “option term,” meaning the length of time that the employee can hold the option before exercising it. If the employee fails to exercise the option within the option term, the option will expire.

Stock options come in two varieties, incentive/statutory stock options, which are awarded either under an employee stock purchase plan or an incentive stock plan, and non-statutory stock options, which are issued under any other type of plan. Incentive stock options receive preferential tax treatment under Sections 421 and 422 of the Internal Revenue Code. At the time the options are exercised there is no taxation. Incentive stock options are taxed at the time that the stock is later sold. If the stock is held for at least one year after the date of exercise and at least two years after the date of grant, the proceeds from the sale of the stock are taxed as long-term capital gain. Long-term capital gains are taxed at a lower rate than regular income.

Among other restrictions, incentive stock options may be granted only to an employee (grants to nonemployee directors or independent contractors are...
not permitted), who must exercise the option while he or she is an employee or no later than three months after termination of employment. If the option holder is disabled, the three-month period is extended to one year. If the option holder dies, the option can be exercised by the legal heirs of the deceased until the expiration date. Each option must be granted under a written agreement identifying the restrictions placed on exercise. Each option must set forth an offer to sell the stock at the option price and the period of time during which the option will remain open. Incentive stock options must be exercised within 10 years of grant. The option exercise price must equal or exceed the fair market value of the underlying stock at the time of grant. Most notably, the incentive stock option cannot be transferred by the option holder other than by will or by the laws of descent. As a result, incentive stock options cannot be transferred from one spouse to another in a divorce, even if there is an agreement between the parties or a court order requiring the transfer.

By contrast, non-statutory stock options are taxed at the time that the option is exercised at ordinary income tax rates. There are no statutory restrictions on transferring a non-statutory stock option, to a spouse or otherwise.

Just like all deferred compensation subject to the regulations set forth in Code Section 409A, stock options are generally awarded subject to a vesting schedule. To exercise an option, that option must be vested. To be vested, the employee must meet certain criteria. The criteria can include continued employment, meeting performance goals, remaining employed for a certain period of time, and so forth.

In a divorce, issues and conflict often arise regarding what portion of stock options are marital property to be divided when they are not yet vested, and what value should be attributed to the options. The issue of whether such options should be treated as assets or as income may also come into play. Issues related to the valuation of the various forms of executive compensation, including stock options, will be discussed further in Chapter 6.

The Tax Cuts and Jobs Act of 2017 (the “TCJA”) did not change the core tax treatment of stock options. However, the TCJA did repeal the deductibility of annual performance-based compensation in excess of $1 million for the CEO, CFO, and the top three highest-paid employees of publicly traded companies under Code Section 162(m). The TCJA also provided for a new type of qualified stock grant for privately held companies, allowing an employee of such an entity to defer income for federal tax purposes at option exercise or restricted stock unit vesting for up to five years provided that the awards meet certain conditions. As a result, we will likely see changes in how publicly traded and privately held companies issue stock awards in the future.