Taking Stock

Understanding the basics about management compensation plans and their tax consequences

OFTEN A KEY ISSUE FOR DIVORCE SETTLEMENTS INVOLVING corporate executives is management compensation. This is true, in part, because the low benefit limits applicable to tax-qualified retirement plans for corporate executives do not apply to management compensation arrangements. Also relevant are corporate earnings and value growth, which are used to determine the amount of benefits provided by such plans.

BY

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To negotiate a meaningful divorce settlement, matrimonial lawyers need to understand what the basic management compensation plans are, how they work, what the range of future benefits may be, and their tax ramifications.

Nonqualified retirement plans

In brief, a nonqualified retirement plan is an unfunded arrangement that permits an employer to provide retirement benefits for a select group of management or highly compensated employees. A nonqualified plan might be useful in the following situations.

First, all 401(k) plan participants are restricted to elective deferrals that do not exceed the individual limit ($16,500 in 2009, with a $5,500 catch-up limit for individuals age 50 and older). Highly compensated participants may have their elective deferrals and matching contributions further limited to an amount that does not exceed the anti-discrimination rules. In addition, the maximum amount of compensation that can be taken into account under a 401(k) or other tax-qualified plan is currently limited to $245,000 under Code section 401(a)(17). Under a nonqualified plan, affected participants could defer excess amounts not permitted to be deferred under a 401(k) plan because of these limitations.

Second, as mentioned earlier, any one employee's benefits are restricted under section 415 of the Code. A nonqualified plan would supplement those benefits that could not otherwise be allocated to a participant under an ESOP or other tax-qualified retirement plan(s).

Finally, benefit shortfalls that affect older employees when a defined benefit plan is terminated can be provided using a nonqualified retirement plan. The nonqualified plan would have a benefit formula that would provide the pretermination projected pension benefit, reduced by benefits received at retirement from the terminated pension plan. However, if the objective is to provide the management team with incentives, the employer could more directly focus on this group by adopting stock-based compensation programs designed to attract, motivate, and retain a core group of top executives to provide management succession.

These arrangements would be separate and apart from any tax-qualified retirement plan and would permit the designated executives to acquire the employer's stock at a minimum acquisition cost, investment risk, and tax cost.

A number of methods are available to accomplish these objectives, including nonqualified stock options, incentive stock options, phantom stock, and stock appreciation rights. One or more of these benefits can be provided in the same plan and can be granted at the same time or separately. Each has distinct advantages and disadvantages for the executive in the company. The employer generally tailors its executive stock program to the financial needs of each executive group on a flexible basis.

Stock-based incentive plans

Following is a more detailed description of many of the stock-based incentive compensation plans an employer may implement to attract and retain a qualified management team. See also the table illustrating stock option tax consequences below and sample document requests at right relating to management compensation.

Code section 409A

Section 409A contains detailed rules relating to the operation of nonqualified retirement plans and executive stock plans. For a more detailed discussion of these rules, see Gregory K. Brown, "What the Matrimonial Lawyer Needs to Know About Non-Qualified Deferred Compensation," 20 *Journal of American Academy of Matrimonial Lawyers*, 2 (2007).

• **Incentive stock option (ISO) plan.** Under an ISO, a company grants a right to a key employee to buy a specified number of shares of company stock during a stated period at a fixed price, typically equal to the stock's per-share value (on the date of grant). Such a plan can restrict the stock purchased pursuant to exercise of an ISO so that the key employee can sell the stock only to the company and only upon termination of employment at a price equal to the value of such stock at the time of the sale. If the key employee exercises an ISO at a time when the value of the stock exceeds the purchase price, he or she will receive an immediate benefit in the form of a bargain purchase. If the stock's value continues to rise, the executive will receive a further benefit since he or she can sell the stock to the company following termination of employment at a price that reflects the further increased value.

To qualify as an ISO, the option must satisfy a number of requirements set forth in Code section 422. Each ISO must be granted in connection with employment under a plan that details both the aggregate number of shares that may be issued upon the exercise of the ISOs and the employees (or class of employees) eligible to receive the ISOs. In addition, shareholders must approve the plan within twelve months of adoption, the ISOs must be granted within 10 years from the later of the plan's date of adoption or date of shareholder approval. The ISOs must be exercised within 10

Sample Tax Consequences

Assume that on January 15, 2009, E, an employee of XO Gray Corp., is granted 10,000 NSOs to purchase shares of XO Gray Corp. common stock at $20 per share and is also granted 10,000 ISOs at $20 per share. On July 15, 2011, when the fair market value of XO Gray Corp. is $30 per share, E exercises all of his/her NSOs and ISOs. On December 15, 2012, when the fair market value of XO Gray Corp. is $40 per share, E sells all the XO Gray stock previously acquired in the July 15, 2011, exercises.

The tax consequences are as follows

Date	NSO Consequences	ISO Consequences
January 15, 2009	None	None
July 15, 2011	• $100,000 ordinary income for regular tax purpose • No alternative minimum tax preferences (AMT) • $100,000 subject to withholding of employment taxes	• No regular income tax • $100,000 AMT tax adjustment • No employment taxes • Potential AMT tax credit carryover may be credited
December 15, 2012	• $100,000 long-term capital gains for income tax purposes • No AMT consequences • No employment taxes	• $200,000 of long-term capital gains purposes for income tax • $100,000 of long-term capital gains for AMT purposes • No employment taxes

—G.K.B.

Request These Documents

Please provide copies of:

1. Any stock option, restricted stock, phantom stock, stock appreciation rights, or other stock-based employee compensation plans, programs, arrangements that may apply to employee.
2. Any award agreements, letters, or other evidence of awards under any such plans, programs, or arrangements.
3. Any employment agreements that make reference to any such plans, programs, arrangements, or awards.
4. Evidence of the exercise or maturity of such awards, including but not limited to W-2 Forms, 1099 Forms, cancelled checks, and copies of award checks.
5. Any plans, programs, or arrangements providing for the deferral of employee's income other than a tax-qualified retirement plan governed by Internal Revenue Code section 401(a).

—G.K.B.

years from the date of grant, and the option price cannot be less than the fair market value of the shares on the date of grant. Finally, restrictions apply to the transferability of ISOs and to ISOs granted to 10 percent stockholders of the employer.

Nontaxable events

Where these requirements are satisfied, neither the grant of the ISO nor its exercise are taxable events to the employee, although the potential for income recognition exists on the date of exercise, since the difference between the value of the stock received on the exercise of the option and the option price constitutes an item of tax preference for purposes of the alternative minimum tax. Similarly, the company granting the ISO receives no deduction, either on the date the ISO is granted or on the date it is exercised.

Absent income recognition by the optionee on the date of exercise under applicable alternative minimum tax rules, gain or loss will be recognized by the key employee receiving an ISO only upon the employee's sale of the stock acquired on the exercise of the ISO. The amount of gain or loss then recognized will equal the difference between (1) the sum realized on the sale of the stock and (2) the sum of any amount paid for the option (presumably zero), plus the amount paid for the stock upon the exercise of the option.

Although the exercise of an ISO does not result in current taxable income, there are consequences with regard to the alternative minimum tax (AMT) under Code section 56. The bargain purchase element of the ISO will be considered as part of AMT income for the year in which the option is exercised.

• **Nonqualified stock option (NSO) plan.** Like ISOs, NSOs are simply contractual rights to buy stock from the issuer at a specified price. Unlike ISOs, their grant is not restricted to employees, and no specific tax law requirements apply. Accordingly, a good deal of flexibility is available in designing NSOs. For example, the price of NSOs need not bear any relationship to the price of the stock being optioned, nor must NSOs be exercised within any particular timeframe. For publicly held companies, Code section 162(m) may require that the price of options granted to certain executives not be less than fair market value on the date of grant.

Whether the granting of an NSO constitutes a taxable event depends first on whether the NSO has a "readily ascertainable fair market value" at the time it is granted. Because NSOs are normally nontransferable and are not immediately exercisable in full, they generally do not have a readily ascertainable fair market value. For this reason, the exercise of the NSO will generally constitute the taxable event for the individuals to whom NSOs are granted.

An individual receiving an NSO will include in income the excess of (1) the fair market value of the stock acquired (as of the date of exercise) over (2) the sum of any amount paid for the NSO (presumably zero), plus the amount paid for stock. The resulting amount will be characterized as ordinary income to the individual. The company granting the NSO will generally be entitled to take a deduction equal to this amount for the company tax year that ends with or includes the end of the year in which the related amount is included in the individual's income.

If shares acquired are subject to the holding period of section 16(b) of the Securities & Exchange Act of 1934, the amount to be included in income will be determined six months after exercise of the NSO, unless an election to have the amount taxed at the time of exercise is made under Code section 83(b).

• **Restricted stock plan.** Under such a plan, an employee generally is granted shares of stock of the issuing company, which are subject to a substantial risk of forfeiture, and transfer restrictions that will lapse only if the recipient remains employed with the company for a specified period after receipt, and/or if certain corporate or individual performance objectives have been achieved. If the employee terminates employment prior to expiration of the restriction period or before satisfaction of performance objectives, he or she will forfeit shares to the company.

If the employee remains with the company until the end of the restriction period, the forfeiture provision will lapse and the employee will own the stock, assuming performance objectives have been achieved. A restricted stock plan also may provide that upon termination of employment the employee can sell acquired stock only to the company. The company's purchase price can be tied to the value per share at the time of the sale. The employer may design the plan to give dividend and voting rights to the holder of restricted stock during the restricted period.

Code section 83(a) provides that an employee receiving stock under such a plan will realize no income for federal tax purposes at the time of the grant (unless he or she files an election pursuant to Code section 83(b)). Rather, the employee will realize income when the restriction or forfeiture provision lapses in an amount equal to the then per-share value multiplied by the number of shares. See Code section 83(a). The company issuing the shares will be entitled to a compensation deduction at that time, equal to the amount taken as income by the employee, to the extent that the amount constitutes reasonable compensation to the employee. Upon sale of the shares to the company, the employee also will realize income or loss, as the case may be.

• **Phantom stock plan.** Under a phantom stock plan, hypothetical shares of a company's stock are allocated by book entry to the account of an employee. No actual cash or shares of stock are set aside by the company to fund future distributions from the phantom stock account.

If the employee remains with the company until the end of the restriction period, the phantom shares in the account are converted to actual shares or cash, or both. Again, a company granting hypothetical shares under a phantom stock plan may utilize a restriction period to prevent any employee from leaving within a set period of years after receiving stock and/or may require satisfaction of performance objectives as a condition to vesting. To the extent phantom shares are distributed in cash, they are valued using the existing value per share of company stock. Shares distributed to an employee may be restricted to sale upon termination of employment and only to the company at a price equal to the value per share at the time of the sale.

An employee receiving a grant of phantom stock realizes no income for federal tax purposes at the time of the award. The employee is taxed at ordinary income rates when distributions are made from the phantom stock account, based on the value of shares distributed, plus any cash received. The company is entitled to a compensation deduction for such amount to the extent the distribution constitutes reasonable compensation to the employee. Upon sale of the shares to the company, the employee realizes income or loss, as the case may be. Should the IRS contest "reasonable compensation," a battle of the experts would ensue.

• **Stock appreciation rights (SAR) plan.** A SAR plan is another management compensation technique that operates in a manner similar to that of a phantom stock plan and has similar tax characteristics. However, in contrast to distributions from a phantom stock plan, distributions from an employee's account in a SAR plan are based only on the increase, if any, in the value per share between the date of the award and the date of distribution. A SAR plan also may allow an employee to choose, either at the time of award or during the prescribed period, the timing of distributions, instead of having to adhere to a maturity date.

• **Stock bonus plan.** Under a stock bonus plan, an employee's bonus is typically contingent on company earnings exceeding a stated level for a specified period (bonus credits). A stock bonus plan allows a company great flexibility and creativity in compensating its key employees. For instance, such a plan can provide that if earnings rise above a certain minimum level, the bonus amounts also will increase, thus providing key employees with an incentive to obtain maximum earnings. The bonuses may be paid in the form of company stock or cash, or both. Again, like other stock-based incentive compensation plans, a stock bonus plan can provide that stock received under the plan can be sold: (1) only to the company, (2) at a price equal to the value per share at the time of transfer, and (3) only upon a termination of employment.

An employee receiving shares under a stock bonus plan realizes no income for federal tax purposes at the time bonus credits are awarded. When the amount of the stock bonus is determined and paid, the employee will realize ordinary income in an amount equal to the value per share, multiplied by the number of shares received, plus the amount of any cash received. The company awarding the bonus credits is entitled to a compensation deduction equal to such amount to the extent it constitutes reasonable compensation to the key employee. When the employee sells the stock to the company, he or she realizes income or loss, as the case may be.

Family law attorneys should be aware that companies may use a number of stock-based incentive compensation plans to further identify the interests of key employees with that of the company. Individual plan documents generally will govern whether or under what terms shares or other rights under the plan can be transferred directly to a spouse or other third party incident to a divorce. Any company adopting such a plan should obtain shareholder ratification of the plan and observe implementation procedures that would avoid or minimize conflicts of interest. A key employee receiving incentive compensation under such a plan will certainly benefit from increases in the company's fair market value and/or book value and may also benefit from favorable federal income tax treatment. **FA**

Gregory K. Brown is a partner at Katten Muchin Rosenman, LLP, in Chicago. His practice emphasizes Employee Stock Ownership Plans (ESOPs), ERISA fiduciary matters, tax-qualified retirement plans, executive compensation and ERISA litigation. Mr. Brown is currently the chair emeritus of the ESOP subcommittee of the American Bar Association's Section of Taxation Employee Benefits Committee. He is a coauthor of *Tax Portfolio on Employee Stock Ownership Plans (ESOPs)*, published by the Bureau of National Affairs.