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What the Matrimonial Lawyer Needs To Know About Non-ERISA Plans, Executive Compensation, and Other Related Plans

by
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I. Introduction

Frequently an important issue arising in divorce settlements of corporate executives is non-ERISA plans, particularly executive compensation and disability plans. This is largely in part because of the relatively low benefit limits imposed on tax-qualified retirement plans for highly compensated employees which are not applicable to nonqualified deferred compensation plans. In addition, executives are typically provided with equity or equity-based incentives to tie their compensation to corporate performance. This is also due to substantial corporate earnings and value growth which is used in part to determine the amount of the account balances and annual benefits provided by such plans.

In any event, the matrimonial lawyer who is confronted by a non-ERISA plan needs to appreciate the law applicable to such plans and the planning opportunities available to use these plans to negotiate a meaningful property settlement. The following article will explore these law changes and planning opportunities.

II. Background

A. *Nonqualified Deferred Compensation Plans*

Nonqualified deferred compensation plans do not meet the qualification requirements under Section 401(a) of the Code[1] and thus do not afford the tax advantages available under tax qualified plans. Benefits under a nonqualified plan are also not

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[1] I.R.C. § 401(a), All references to the Code herein are to the Internal Revenue Code of 1986, as amended, and section references are to this Code.

guaranteed and therefore offer employees far less security than benefits provided pursuant to a qualified plan. These plans are typically limited to executives and are designed as a means of allowing executives to forego current income (and current taxation) until retirement or some other date when, presumably, they may enjoy a lower income tax bracket. Some plans provide for the deferral of salary; others involve a deferral of bonus and/or incentive compensation; many include both features.

Structured in this manner, the nonqualified deferred compensation plan may serve one or more needs:

- as a supplement to the existing compensation package to attract and retain senior management;
- as a pension supplement to bypass the Code section 415 benefit limits;
- as a pension supplement to attract key employees who will suffer a reduction in overall retirement plan benefits because of a midcareer or late-career employment change;
- as a feature of an early retirement program or a "golden parachute plan";
- in a closely-held company, as a substitute for equity incentive programs;
- as a device for the deferral of fees earned by members of the board of directors; and
- as an executive supplement to the employer's 401(k) plan, allowing deferrals by executives that cannot be made under the 401(k) plan because of the contribution limits and testing thereunder.

The deferred payment may take one of several forms. These include deferred stock, deferred investments, life insurance, cash, or a combination thereof. By far the most usual form is cash. The deferred income is often credited with an interest factor under a predetermined formula. The deferred income grows in the "deferral account" and, at some future date, is paid out to the executive.

The most important factor for nonqualified deferred compensation is flexibility. The freedom to choose participants on a discretionary basis and the relative freedom from the Employee Retirement Income Security Act of 1974, as amended ("ERISA"),[2] and other regulatory guidelines make these attractive vehicles to provide compensation. However, the typical plan is a mere unfunded promise by the employer to pay the deferred

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2 29 U.S.C. §§ 1001-1461 (2000).

amounts in the future for which the executive may be foregoing current compensation. As an unfunded program, the deferred amounts are paid out of the employer's general assets, subject to the rights of general creditors of the employer.[3]

B. *Long-Term Incentives*

Long-term incentive plans are variable compensation earned over a period of more than twelve months. These programs are perceived by investors to be the most influential in shaping individual efforts and decision-making in support of long-term corporate goals and objectives. This makes it critically important that proper measures of performance are identified that correlate well with corporate success and allow for appropriate levels of reward through the corporation's long-term incentive plans.

Stock options have traditionally been a prevalent form of long-term compensation. These plans provide executives with an opportunity to purchase the corporation's stock at a set price for a fixed period of time. The option price is normally equal to the fair market value of the stock on the date the option is granted. Once the option is exercised, the executive is free to sell the purchased shares or hold them for future appreciation. Stock options are granted in two forms: incentive stock options (ISOs) or nonqualified stock options (NQSOs). ISOs must conform to special rules set forth in the Internal Revenue Code. Options that do not meet those requirements are classified as NQSOs.

Stock appreciation rights (SARs) are also a prevalent form of long-term incentives. Similar to a stock option, a SAR gives the executive the ability over an extended period of time to realize the appreciation in value of his employer's stock from the grant date to the date of exercise. However, with a SAR, the executive does not actually purchase the stock. Rather, the corporation simply pays the spread at the date of exercise in cash or shares, or both.

Restricted stock has become more prevalent than either stock options or SARs, largely because of accounting and dilution considerations. A restricted stock arrangement gives the executive actual shares of his employer's stock subject to vesting requirements, typically the rendering of service over a defined

[3] § 83; Rev. Rul. 60-31, 1960-1 C.B. 174.

period and achievement of certain performance goals during that period. If the executive does not fulfill these vesting requirements, the shares are forfeited and revert back to the employer. During the vesting period, however, the executive usually has voting and dividend rights with respect to the shares.

Restricted stock units (RSUs) are also newly prevalent. These are phantom stock units that track the actual stock price but are not represented by actual shares of stock. The units represent a promise by the employer to pay the shares at some future date. The units are normally subject to the same vesting requirements as restricted stock. RSUs do not have voting rights or dividend rights.

Performance unit/performance share plans are offered by a large percentage of publicly-traded companies. These plans are designed to pay awards if the corporation meets predetermined, long-term performance objectives (for example, return on equity). At the beginning of the performance period, the employer establishes goals designed to measure the degree of success during the performance period, typically three to five years. The corporation's compensation committee approves the goals proposed by senior management and decides the manner in which payouts are to be calculated. These goals may be financial or operational in nature. One or more measures are often used.

Generally, an executive receives a grant of such units or "stock" at no cost. Normally, no stock is granted or transferred until the end of the performance period. The executive then earns the right to receive the monetary value of some or all of the units or stock at the end of the performance period. Normally, these plans provide for minimum, target, and maximum levels of performance and the payout amounts at each level.

At the end of the performance period, performance is assessed and awards paid. The value to be received depends upon the company's long-term performance. For example, an executive may be granted 5,000 units that will pay $1,000 each if certain target goals are achieved. If performance is above the targets, the employee may receive additional units that pay out at the same rate ($1,000 each) or at a higher payout per unit ($1,250 each). Performance units are typically paid in cash, but may be paid in a combination of cash and stock.

C. *Other Executive Arrangements*

In addition to long-term incentives and nonqualified deferred compensation, executive compensation packages typically include other benefits. These benefits are often an extension of broad-based benefit plans and are designed to meet one or more of the following objectives:

- provide welfare benefits that would otherwise have been provided under broad-based plans were it not for vendor limitations (*e.g.,* disability insurance coverage maximums) or tax-rules (*e.g.,* treatment of discriminatory group term life plans);
- enhance the overall level of welfare benefits beyond that of broad-based plans; and
- introduce new welfare plans not available under the company's broad-based plans.

These objectives are met by using one or more of the following executive plans:

- executive vacation benefit plans; and
- executive death and disability plans.

III. Tax Treatment

Distributions from nonqualified plans are taxed to an employee when they are distributed or made available to the employee. The employer receives a corresponding deduction in the same tax year. The doctrine of constructive receipt may force immediate taxation even though payment is structured for a later date.[4] However, compensation deferred under nonqualified plans that do not satisfy the applicable election, distribution, and funding restrictions under section 409A will be subject to tax and interest assessments in the year of deferral, to the extent not subject to a substantial risk of forfeiture and not previously included in gross income.[5]

A. *Section 409A*

Section 409A became part of the Code by virtue of the American Jobs Creation Act of 2004.[6] Under section 409A, benefits deferred under non-qualified deferred compensation plans

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4 Treas. Reg. § 1.451-2(a).

5 § 409A(a).

6 Pub. L. No. 108-357, 118 Stat. 1418 (codified at 26 U.S.C. § 1 (2005)).

must be included in income to the extent they are not subject to a substantial risk of forfeiture and not previously included in income, unless the plan complies with section 409A both in form and in *operation*.

1. *Basic Rules*

Under section 409A, compensation is subject to a substantial risk of forfeiture if entitlement to the compensation is conditioned on either of the following:

(1) the performance of substantial future services by any person; or
(2) the occurrence of a condition related to the purposes of the compensation.[7]

A "condition related to the purpose of the compensation" must relate to the executive's performance for the employer or the employer's business activities or organization goals.[8] Examples of this permissible purpose would include the attainment of a prescribed level of earnings or a certain equity value. The executive is referred to in the rules by the term "service provider," which includes any individual, partnership or corporation.[9]

If the conditions for inclusion of income under section 409A are satisfied, the compensation deferred under the nonqualified deferred compensation plan (and related earnings) for that year and all preceding years that the nonqualified deferred compensation plan has been in place and subject to section 409A will be includible in the executive's taxable income in the year of the failure, to the extent not subject to a substantial risk of forfeiture and not previously includible in gross income; this would be the case for an executive whose non-qualified deferred compensation vests only upon completion of 5 years of service and achievement of specific corporate financial performance. Fur-

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7 Regs. § 1.409A-1(d)(1).

8 *Id*.

9 Regs. § 1.409A-1(f). For more background on this issue, see Alpern, *"Ten Items Estate Planners and Tax Advisors Need to Know About Code §409A Deferred Compensation Rules*," 21 Prob. & Prop. 32, Hogans and Collins, *"Internal Revenue Code Section 409A: 10 Traps for the Unwary*," 27 Tax Mgmt. Wkly. Rpt. 301 (Mar. 3), Feuer, *"The Effects of Marital Property Rights, Alimony, Child Support, and Domestic Relations Orders On Top-Hat Plans, Excess Benefit Plans, and Bonus Plans,"* 38 Tax Mgmt. Compensation Plan. J. 319.

ther, the executive will be subject to additional tax liability equal to:

(1) interest at the IRS underpayment rate plus one percentage point on the underpayment amount that would have been included in income when first deferred or, if later, when it was not subject to a substantial risk of forfeiture; and
(2) an additional 20% tax on the amount deferred that is required to be included in taxable income pursuant to section 409A.[10]

The provisions of section 409A do not prevent the inclusion of amounts in gross income under any other Code provision.

Section 409A applies to amounts deferred in tax years beginning after 2004, and to amounts deferred in tax years beginning before 2005 if the nonqualified deferred compensation plan under which the deferral is made is materially modified after October 3, 2004, or if the deferred amount was not vested as of December 31, 2004.[11]

2. *What Is a Nonqualified Deferred Compensation Plan for Purposes of Section 409A?*

The term "nonqualified deferred compensation plan" is defined very broadly as any plan that provides for the deferral of compensation.[12] The Code and the proposed regulations *exclude* several arrangements from the definition for purposes of section 409A, such as tax-qualified plans under section 401(a), annuity plans described in section 403(a), annuity contracts described in section 403(b), simplified employee pensions under section 408(k), deferred compensation plans described in section 457, and simple retirement accounts under section 408(p).[13] The term "plan" is defined broadly to include any agreement, method, or arrangement, including an agreement, method, or arrangement that applies to only one person or individual.

3. *Long-Term Incentives*

The grant of an incentive stock option ("ISO") or the grant of an option under an employee stock purchase plan described in

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10 § 409A(a)(1)(B).
11 Regs. § 1.409A-6(a)(1).
12 § 409A(d)(1).
13 *Id*. Regs. § 1.409A-1(a)(2).

section 423 is not subject to section 409A.[14] However, nonqualified stock options ("NSOs") and stock appreciation rights ("SARs") with an exercise price and strike price, respectively, that are below the fair market value of the underlying employer stock at the date of grant are subject to the requirements of section 409A.[15] The right to receive all or part of the dividends declared and paid on the number of shares underlying the stock right between the date of grant and the date of exercise of the stock right constitutes an offset to the exercise price of the stock option or an increase in the amount payable under SARs, thereby causing the grant to be subject to section 409A.[16]

For purposes of determining whether an NSO is covered by section 409A, any reasonable valuation method may be used. In the case of employer stock that is not readily tradable on an established securities market, the fair market value of the stock as of a valuation date means a value determined by the reasonable application of a reasonable valuation method.[17] The determination of whether a valuation method is reasonable, or whether an application of a valuation method is reasonable, depends on the facts and circumstances as of the valuation date.[18] The regulations provide for three valuation methods.[19] Provided that an employer uses one such method reasonably and consistently, the valuation determined by applying such method is presumed to equal the fair market value of the stock, and such presumption is rebuttable only by showing that the valuation is grossly unreasonable.[20]

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14 Regs. § 1.409A-1(b)(5)(ii).

15 Regs. § 1.409A-1(b)(5)(i).

16 Regs. § 1.409A-1(b)(5)(i)(E).

17 Regs. § 1.409A-1(b)(5)(iv).

18 *Id.*

19 Regs. § 1.409A-1(b)(5)(iv)(B)(2). The three safe harbor methods are (1) appraisal from a qualified, independent appraiser that was issued no more than twelve months before a stock right grant, (2) formula-based valuation that would constitute a non-lapse restriction under Section 83 that will, by its terms, be used while stock is not publicly-traded, and (3) for illiquid start-up companies, a good faith valuation evidenced by a written report issued by a qualified appraiser (no independence required).

20 *Id.*

4. *Deferral Elections*

The section 409A regulations govern both a participant's election to defer compensation and the election of the form of a distribution.

Initial elections to defer compensation for services performed during a year must, under the new rules, generally be made no later than the close of the preceding tax year.[21] Thus, a plan may no longer authorize an executive to make deferral elections during the year in which services are provided. Newly eligible executives are allowed to make the election within 30 days after becoming eligible to participate in the plan.

An executive may make an election to defer "performance based" compensation (that is based on services performed over no less than a twelve-month period) no later than six months before the end of the service period.[22] Performance based compensation is defined as including compensation to the extent that the amount is: (1) variable and contingent on the satisfaction of pre-established organizational or individual performance criteria, and (2) not readily ascertainable at the time of the election.[23]

Executives must generally specify the time and form of distributions at the time of the initial election. However, executives are allowed to make a subsequent election to delay a payment or change the form of payment.[24] The subsequent election may not take effect, however, for at least twelve months after the date on which the subsequent election is made. In addition, the first payment for which the additional deferral election is made (other than payments related to death, disability, or the occurrence of an unforeseeable emergency) must be deferred for no less than five years from the date the payment would otherwise have been made.[25] An election related to a payment that is to be made at a specified time or pursuant to a fixed schedule may not be made earlier than twelve months before the date of the first scheduled payment.

21 § 409A(a)(4), Regs. § 1.409A-2(a).

22 § 409A(a)(1)(B)(iii), Regs. § 1.409A-2(a)(8).

23 Regs. § 1.409A-1(e).

24 Regs. § 1.409A-2(b).

25 Regs. § 1.409A-2(b)(ii).

5. *Distribution Timing*

Section 409A requires that payments be made from a plan at a fixed date, under a fixed schedule, or upon one of five events:

(1) separation from service,
(2) death,
(3) disability,
(4) change in ownership or effective control of a corporation, or
(5) unforeseeable emergency.[26]

The regulations provide that, if the time of payment is based on the occurrence of one of the five events listed above, the plan must designate an objectively determinable date or year following the event on which the payment is to be made.[27] In addition, a payment is treated as made on the date specified under the arrangement if such payment is made (i) on such date, or (ii) at a later date within the same calendar year, or (iii) if later, the fifteenth day of the third month following the specified date under the arrangement.[28]

The term "payment" refers to each separately identified amount to which an executive is entitled to payment.[29] The entitlement to a series of installment payments (that is not a life annuity) is treated as the entitlement to a single payment, unless the arrangement provides with respect to the amount deferred that the right to the series of installment payments is at all times to be treated as a right to a series of separate payments.[30]

Any of the following three change-in-control events may trigger a distribution:

(A) a change in the ownership of a corporation,
(B) a change in the effective control of a corporation, or
(C) a change in the ownership of a substantial portion of the assets of the corporation.[31]

A change-in-control event may occur that does not relate to the entire group of affiliated corporations, but rather, to the corporation for whom the executive provided services, or a majority shareholder of such corporation, or all of the corporations liable

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26 Regs. § 1.409A-3(a).
27 Regs. § 1.409A-3(b).
28 Regs. § 1.409A-3(d).
29 Regs. § 1.409A-2(b)(2)(i).
30 Regs. § 1.409A-2(b)(2)(iii).
31 Regs. § 1.409A-3(i)(5).

for the payment to such service provider undergo a change-in-control event.[32] A change in ownership of a corporation occurs on the date that any one person, or more than one person acting as a group, acquires ownership of the stock of the corporation that, together with stock held by such person or group, constitutes more than 50% of the total fair market value or total voting power of such corporation.[33]

A change in the effective control of a corporation occurs on the date that (1) a person, or more than one person acting as a group, acquires 35% or more of the total voting power of stock over a period of twelve months or less, or (2) a majority of the members of the corporation's board of directors is replaced during any twelve-month period by directors whose appointment or election is not endorsed by a majority of the members of the corporation's board of directors prior to the date of appointment or election, provided that such corporation is a corporation for which there is no majority shareholder.[34] A change in the ownership of a substantial portion of a corporation's assets occurs on the date that any one person, or more than one person acting as a group, acquires assets from the corporation that have a total gross fair market value equal to or greater than 40% of the total gross fair market value of all the assets of the corporation immediately prior to such acquisition.[35]

a. *Unforeseeable emergency*

A distribution can be made from a plan in the event of an "unforeseeable emergency."[36] An unforeseeable emergency is defined as a severe financial hardship of the executive or beneficiary resulting from an illness or accident of the service provider or beneficiary, or the spouse or dependent of either; the loss of the executive's or beneficiary's property due to casualty; or other similar extraordinary or unforeseeable circumstance arising as a result of events beyond the control of the executive or beneficiary.[37] A distribution cannot be made in the event of unfore-

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32 Regs. § 1.409A-3(g)(5)(ii).
33 Regs. § 1.409A-3(g)(5)(v).
34 *Id.*
35 Regs. § 1.409A-3(g)(5)(vii).
36 Regs. § 1.409A-3(i)(3)(i).
37 *Id.*

seeable emergency to the extent that the emergency is or may be relieved through reimbursement or compensation from insurance or otherwise, by liquidation of the executive's assets to the extent that the liquidation of the assets would not itself cause severe financial hardship, or by ceasing deferrals under the arrangement.[38]

b. *Domestic relations order*

Further, a plan may permit acceleration of the time or schedule of a payment under the arrangement to an individual other than the executive as may be necessary to fulfill a domestic relations order (as defined in section 414(p)(1)(B)). Thus, a nonqualified plan may be a source to help settle a divorce through acceleration of payments to the non-employee spouse; the order does not need to fulfill the formal requirements of a qualified domestic relations order, but the plan in question must have provisions allowing such acceleration. An order to accelerate payment to the executive's spouse or former spouse need *not* fulfill all of the technical requirements for a "qualified domestic relations order," but using those requirements as a guidepost for such an order will likely prove useful in obtaining the desired payments.[39]

c. *Intervening event*

A plan may *not* permit the acceleration of the time or schedule of any payment under the nonqualified deferred compensation plan.[40] An impermissible acceleration does *not* occur if payment is made in accordance with plan provisions or an election as to the time and form of payment in effect at the time of initial deferral (or added in accordance with the rules applicable to subsequent deferral elections under the Proposed Regulations section 1.409A-2(b)) pursuant to which payment is required to be made on an accelerated schedule as a result of an intervening event that is a permissible distribution event under section 409A.[41] Thus, a plan may provide that an executive will receive five installment payments commencing at separation from ser-

38 Regs. § 1.409A-3(i)(3)(ii).

39 Regs. § 1.409A-2(b)(4), Regs. § 1.409-3(j)(4)(ii).

40 Regs. § 1.409A-3(j)(i).

41 *Id*.

vice, and may also provide that if the executive dies after such payments commence but before all payments have been made, all remaining amounts will be paid in a lump sum payment.[42]

d. *Vesting waiver*

Additionally, it is *not* an impermissible acceleration of the time or schedule of payment if the employer waives or accelerates the satisfaction of a condition constituting a substantial risk of forfeiture applicable to such deferral of compensation, provided that the requirements of section 409A (including the requirement that the payment be made upon a permissible payment event) are otherwise satisfied with respect to such deferral of compensation.[43] For example, if a plan provides for a lump sum payment of the vested benefits upon separation from service, and the benefits vest under the plan only after ten years of service, it is not a violation of the requirements of section 409A if the employer reduces the vesting requirement to five years of service, even if an executive becomes vested as a result thereof and receives a payment in connection with a separation from service before the employer would have completed ten years of service.[44]

e. *Miscellaneous*

Furthermore, a plan may provide that a payment will be delayed where a publicly-traded employer reasonably anticipates that the employer's deduction for such payment would otherwise be limited or eliminated under the public company deduction limitation provisions of section 162(m). However, the terms of the deferral arrangement must require the payment to be made either at the earliest date on which the employer reasonably anticipates that the deduction for such payment will not be limited

42 *Id.*

43 *Id.*

44 *Id.* Some of the other exceptions to the prohibition on acceleration of payments are: (1) a payment pursuant to a domestic relations order; (2) a payment to comply with ethics agreements with the federal government; (3) a payment of a *de minimis* amount that is not greater than $10,000, within specified time limits, and (4) amounts necessary to accelerate the payment of FICA and income tax. Prop. Regs. § 1.409A-3(h)(2).

or eliminated by application of section 162(m) or the calendar year in which the executive separates from service.[45]

Finally, a plan may provide that a payment will be delayed where the employer reasonably anticipates that the making of the payment will violate federal securities laws or other applicable law, provided that the terms of the arrangement require the payment to be made at the earliest date on which the employer reasonably anticipates that the making of the payment will not cause such a violation. For this purpose, the making of a payment that would cause inclusion in gross income or the application of any penalty provision or other provision of the Code is *not* treated as a violation of applicable law.[46]

B. *Tax Treatment of Long-Term Incentives and Other Benefits*

1. *Incentive Stock Options (ISOs)*

Under ISOs, the executive does not recognize ordinary income at the time of the grant of the option or upon the exercise of the option.[47] (However, the "spread" between the exercise price and the stock's fair market value (FMV) at exercise is subject to the alternative minimum tax.)[48] Following the exercise of an ISO, income tax on the stock's appreciation is deferred until the stock is sold.[49] At that time the entire "spread" is taxed at capital gains rates (provided that certain holding periods are met).[50] The employer receives no tax deduction under an ISO unless the executive disposes of the stock before the one-year holding period has expired.[51]

2. *Non-qualified Stock Options (NQSOs)*

An executive will recognize income upon the exercise of a NQSO in an amount equal to the "spread" between the exercise price and the stock's FMV on the date of exercise.[52] Following exercise, income tax on the stock's appreciation is deferred until

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45 Regs. § 1.409A-2(b)(7)(i).
46 Regs. § 1.409A-2(b)(7)(ii).
47 Code §§ 83(c), 421(a), 422(a).
48 Code § 56(b)(3).
49 Code § 1001(a).
50 *Id.*
51 Code §§ 421(a)(2), 422(a).
52 Code § 83(e)(3).

the stock is sold (and, at that time, the appreciation from the date of exercise is taxed as a capital gain).[53] The employer is entitled to a tax deduction equal to the "spread" at exercise.[54]

3. *Stock Appreciation Rights (SARs)*

There are no tax consequences to the company or the employee upon the grant of a SAR.[55] Upon exercise of the SAR, the employee will recognize ordinary income in the amount of the appreciation.[56] The employer then receives a corresponding deduction in the same amount.[57]

4. *Restricted Stock*

Restricted stock is taxed when it is no longer subject to a substantial risk of forfeiture, that is, the performance of substantial services is no longer required for the restrictions to lapse.[58] Any dividends paid to the employee during the restricted period are taxed as ordinary income when paid.[59] When the restrictions lapse, the employee recognizes ordinary income equal to the current FMV of the stock less any amount paid by the employee for the stock.[60] Subsequent appreciation is taxed at capital gains rates when the stock is sold.[61]

The employer is entitled to a deduction at the time the restrictions lapse in the amount of the FMV of the stock upon vesting.[62] The employer will also be entitled to a deduction for the amount of any dividends paid to the employee prior to vesting.[63]

5. *Restricted Stock Units ("RSUs")*

A RSU is taxed as ordinary income when the employee receives the payment for the RSU.[64] There is no tax at grant or at

53 Code § 1001(a).
54 Code § 83(h).
55 Code § 61.
56 Rev. Rul. 80-300, 1980-2 C.B. 165.
57 Code § 404(a)(5) (cash) and 83(h) (stock).
58 Code § 83(a).
59 Regs. § 1.83-1(a)(1).
60 *Id.*
61 Code § 1001(a).
62 Code § 83(h).
63 Code § 162.
64 Code § 61.

vesting, just upon payout of the RSU.[65] The company recognizes a corresponding deduction at the time of recognition of income by the executive.[66]

6. *Performance Unit/Performance Share Plans*

The executive must recognize ordinary income in the year the award is received.[67] The company will receive a corresponding deduction.[68]

7. *Executive Life Insurance*

Group term life insurance allows an employee to exclude from income the first $50,000 of insurance coverage. However, key employees are subject to tax on the cost of insurance provided under a discriminatory plan.[69]

Individual life insurance is often used to fund non-qualified executive compensation, with a "split-dollar plan." Under such an arrangement, the employer pays the part of the annual premium equal to the increase in cash value of the policy during the policy year. The balance is paid by the executive. The employer is the beneficiary of the cash value of the policy. The executor's named beneficiary is entitled to the remaining proceeds. The non-discrimination rules do not apply to split-dollar arrangements.

Executives under split-dollar arrangements are generally taxed on the net premium cost of the current insurance (i.e., the value of the insurance protection) reduced by the amount of premiums they pay.[70] The IRS has provided two mutually exclusive methods for taxing split-dollar arrangements. One is an economic benefit method, and the other is a loan method. Ownership of the life insurance contract determines which method applies. If the executive is the owner, the executive's premium payments are treated as loans to the executive. If the employer is the owner, the employer's premium payments are treated as providing taxable economic benefit to the executive. Such benefits

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65 *Id.*
66 Code § 162.
67 Code § 61.
68 Code § 162.
69 Code § 79(d)(1).
70 Regs. § 1.61-2(d)(2)(ii)(A).

include the executive's interest in the policy cash value and current life insurance protection.[71]

Generally, split-dollar arrangements that provide for deferred compensation as defined in Regs. § 1.409A-1(b) are subject to the requirements of Code Section 409A.

Under a reverse split-dollar arrangement, the employer and the executive split the premium payments and, upon the executive's death, the executive's beneficiary receives the amount of the executive's premium payments and interest thereon. The employer receives the balance of the proceeds. An executive is not entitled to deduct the premiums paid for split-dollar insurance protection. The executive is not taxed on the cost of current life insurance protection because the executive does not receive the actual amount of insurance coverage.

8. *Executive Disability Coverage*

The purchase of group disability coverage does not result in taxable income to the executive.[72] However, when disability insurance payments are made under the plan to a disabled executive, taxable income will result.[73]

With regard to individual disability insurance provided by the employer for an executive, the tax impact depends on who is paying the premiums. If the employer owns the disability policy and pays the premiums, these premiums are not taxable to the executive.[74] If the executive owns the policy and pays the premiums, the employer will normally cover the cost of the premium by paying additional compensation to the executive. This compensation is taxable to the executive at the time it is paid, but disability benefits paid to the executive are not taxable.[75]

If the disability insurance premiums are paid either directly or indirectly by the employer and these premium payments are not taxable to the executive when made, disability income benefits paid from the insurance will be fully taxable to the executive.[76]

71 Regs. § 1.61-22.
72 Code § 104(a)(13).
73 Code § 105(a).
74 Code § 106.
75 Code § 104(a)(3).
76 Code § 105(a).

C. *Tax Consequences of Transfers*

The tax consequences of transfers of nonqualified deferred compensation to the non-employee spouse must be given careful consideration by both parties. Fortunately, the IRS now takes the position that the non-employee spouse steps into the shoes of the employee spouse with respect to taxation.

In Revenue Ruling 2002-22, the IRS held that section 1041 confers nonrecognition treatment on any gain that the employee spouse might otherwise realize when transferring a nonqualified deferred compensation interest to a former spouse.[77] This is the same for community property jurisdictions and non-community property jurisdictions.

Thus, an executive who transfers an interest in a nonqualified deferred compensation plan to a former spouse incident to divorce is not required to include an amount in gross income upon the transfer, provided that the executive has properly complied with the section 409A rules.[78] The amounts realized from payments of deferred compensation must be included in the former spouse's income in the year such payments are paid or made available. The executive is not required to include such payments in his or her income.

Subsequent to issuing Revenue Ruling 2002-22, the IRS issued Notice 2002-31, which provides that no payment of wages for employment tax purposes is deemed to be made upon the transfer of interests in nonqualified deferred compensation from an employee spouse to a non-employee spouse incident to divorce.[79] Nonqualified deferred compensation payments also remain subject to Federal Insurance Contributions Act (FICA) and Federal Unemployment Tax Act (FUTA) taxes to the same extent as if the rights to the compensation had been retained by the employee spouse.

Revenue Ruling 2004-60 was later issued to modify Notice 2002-31 to provide that nonqualified deferred compensation transferred by an employee to a former spouse incident to di-

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77 Rev. Rul. 2002-22, 2002-1 C.B. 849.

78 *See al*so I.R.S. Priv. Ltr. Rul. 200442003 (Oct. 15, 2004). *See, e.g.,* Thomas R. White, III, *Employment Taxes and Stock Options: How an Employee Divorce Affects Your Company*, 13 EMP. L. STRATEGIST 3 (Sept. 2005) (discussing when a "transfer occurs" for purposes of this rule).

79 Notice 2002-31, 2002-1 C.B. 908.

vorce is subject to FICA and FUTA, and income tax withholding is required to the same extent as if retained by the employee.[80] To the extent that employment taxes apply, the wages are considered as the wages of the employee spouse. The employee portion of the FICA taxes would be deducted from the payment made by the employer to the former spouse, and any FICA withholding from the payments would not reduce the amount includible in the gross income of the former spouse.

Amounts distributed to a nonemployee spouse from a nonqualified deferred compensation plan are subject to federal income tax withholding under section 3402.

IV. Conclusion

It is crucial that a matrimonial attorney working on a divorce involving a corporate executive understand the new rules applicable to nonqualified deferred compensation and long-term incentive plans and how they affect the availability of funds that are part of the marital estate. This will require specific document requests and close scrutiny of the relevant documents produced to see which payments may be accelerated or delayed and whether any domestic relations order may be used to obtain funds for settlement.

It is extremely important to request and review all applicable documents governing a nonqualified deferred compensation plan or arrangement in order to understand which payments thereunder may be accelerated or delayed. This will allow the matrimonial attorney to understand the possibilities for structuring a settlement which is based, in part, on such payments.

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80 Revenue Ruling 2004-60 provides: "For periods before the effective date, employers may rely on a reasonable, good faith interpretation including the interpretations in the proposed revenue ruling in Notice 2002-31 and this revenue ruling. However, with respect to compensation transferred to a spouse incident to divorce, failure to treat nonstatutory stock option compensation, or amounts deferred under a nonqualified deferred compensation plan, as subject to FICA will not be considered a reasonable, good faith interpretation." Rev. Rul. 2004-60, 2004-24 I.R.B. 1051 (June 14, 2004).