



DIVORCE
FINANCIAL PLANNER
Training Center

Executive Compensation

The Ultimate Guide for Divorce Financial Planners

Overview

The goal of today's session is to give you an in-depth understanding of exactly how to handle the most common executive compensation awards in a divorce situation.

RSUs have become the new normal so we will spend most of our time on them but as stock options are still fairly common, we'll cover them also.

Issues to Address

- Are they marital?
- Are they vested?
- Will they be valued?
- How will they be divided?
- What are the tax implications?
- Will they be considered an asset, income or both for purposes of spousal maintenance and child support?

Are they
marital?

Whether options or RSUs, if they are awarded and VESTED during the marriage, they are 100% marital.

If not vested, must determine purpose of award, past service or future performance

Apply coverture fraction to determine marital shares

Stock Options

Incentive Stock Options

- Not taxed upon exercise, taxed upon the sale of the underlying stock
- If the shares are held for 1 year from the date of exercise and 2 years from the date of grant, then the profit (if any) made on sale of the shares is taxed as long-term capital gain.

Non Qualified Stock Options

- Taxed upon exercise.
- Taxed on the difference between the exercise price (strike) and the fair market value of the stock on the date of exercise at ordinary income rates.

ISOs

- To qualify for favorable treatment under IRC
 - Need a written plan
 - Can only be awarded by corporations
 - Can only be awarded to employees
 - Must be employed on the date of the award and remain an employee 3 months prior to exercise
 - Must be exercised within 10 years
 - Cannot be transferred except upon death
 - Must exercise 3 months after termination
 - If termination is due to death or disability allow 1 year to exercise
 - Exercise Price must not be less than FMV of stock on date of award

ISO – cont.

- If the employee owns 10% or more of the corporation
 - The exercise price must be at least 110% of the FMV of the stock on the grant date
 - Must be exercised within 5 years of the grant date

Non-Qualified Stock Options - NQSO

- If you fail to meet the requirements of the IRC the options are deemed to be Non Qualified
- More flexibility
 - Can grant to non-employees (consulting firms, etc.)
- No special tax treatment
 - Ordinary income treatment on the date the employee exercises the option.

- Division
 - “In Kind”
 - Can they be transferred? Do you need to impose a Constructive Trust/include direction language
 - Intrinsic Value
 - Difference between the market value of the stock at the date of valuation (date of divorce) and the strike price
 - SIMPLE
 - JUDGES UNDERSTAND

Division

- Black Scholes Pricing Model
 - Model that factors in various features of the option such as strike price and time to maturity as well as features of the underlying stock such as current price and historical price volatility which is then adjusted by a risk free rate of return
 - COMPLICATED
 - JUDGES DON'T UNDERSTAND
- Binomial Method
 - Similar to Black Sholes Method – creates a tree of possible option values based on the variables Black Scholes uses
 - COMPLICATED
 - JUDGES DON'T UNDERSTAND

Black-Scholes

- This method computes the value of the options using a formula. The formula determines the present value by taking into account the stock's current price, dividend rate, assumptions regarding a risk free interest rate, time value, and the stock's price volatility.
- A weakness in the Black Scholes method is its assumption that the employee does not exercise the option until the last day, when in reality employees can exercise options at any time after they are vested. However, **Black Scholes is still by far the most widely used method for valuing Employee Stock Options.**

$$C = SN(d_1) - Xe^{-rTN}(d_2)$$

$$\text{Where: } d_1 = 1n\left(\frac{S}{X}\right) + \left(r + \frac{\sigma^2}{2}\right)T$$

$$d_2 = 1n\left(\frac{S}{X}\right) + \left(r - \frac{\sigma^2}{2}\right)T = d_1 - \sigma\sqrt{T}$$

Where: S = Stock Price

X = Strike Price

r = Risk-free rate of return (30 yr treasury)

T = Time to expiration in years

σ = Volatility of stock price

N(x) = Cumulative normal distribution function

Black-Scholes Formula

Black-Scholes Calculator

- <https://www.mystockoptions.com/black-scholes.cfm>

myStockOptions.com: Black-Scholes Calculator

Black-Scholes Calculator

To calculate a basic Black-Scholes value for your stock options, fill in the fields below. The data and results will not be saved and do not feed the tools on this website. Remember that the actual monetary value of vested stock options is the difference between the market price and your exercise price.

To learn more about the the Black-Scholes method of valuing employee stock options, see our Valuation & Expensing section.

Black-Scholes Value:

Stock Price: (in USD)	<input type="text"/>	(ex. 31.55)
Exercise Price: (in USD)	<input type="text"/>	(ex. 22.75)
Time to maturity: (in years)	<input type="text"/>	(ex. 3.5)
Annual risk-free interest rate	<input type="text"/>	(ex. 5%)
Annualized volatility	<input type="text"/>	(ex. 50%)

This calculator does not consider dividends paid on your stock and would thus not be accurate for companies that pay them. ⓘ

Like this calculator? Don't miss out on the other tools and content from myStockOptions.com!

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Example

- CVS Options at 45. Vest in one year
- CVS Stock has a daily STD of .7782 (googled)
- 10 yr treasury yield of 2.18
- =SQRT(252)*STD (Type this into Excel)
- CVS STD = .7782 Annual Volatility = **12.354**
- **So .97 of time value on the option.**

- The Binomial (or Lattice Method) is a complex formula that creates a tree of possible option values based on the same variable as the Black Scholes method. Additionally, it takes into account the potential early exercise of options rather than assuming the optionee holds them until the latest exercise date. This method tends to produce a slightly lower value and is not as widely utilized as the Black Scholes Method.
- Neither method takes into account the potential tax effects of exercising the options. Both income and payroll tax consequences reduce the after-tax present value of the options, and clients should be made aware of potential tax consequences.

Binomial Method

- Income from the exercise of stock options is considered compensation for purposes of child support calculations. There is nothing definitive as to whether the income from stock options that have been present valued and traded for another asset is includable in child support calculations.
- However, there seems to be no doubt that options granted after the date of separation would be included in child support calculations. See, e.g., *Marriage of Kerr* (1999) 77 Cal App. 4th 97, 95.

Stock Option Income Includable for Support

- The stock option plan document
- Internal correspondence issued by the company at the time of the grants, usually an email or letter
- A schedule of the grants showing:
 - Date of each option granted
 - Number of options granted at each date
 - Exercise price for each option
 - Expiration date of each set of options
 - Date of vesting for each set of options
- A transaction history of options that have been exercised showing the date and number of options exercised

Documentation
Needed

Restricted Stock and RSUs

Why RSUs and Restricted Stock instead of Options?

- Easier to understand the value. No Black-Scholes valuation needed
- Both: Accounting Treatment – Adoption of FAS 123R removed favorable tax treatment of options.
- Overhang/Number of Shares – Fewer shares need to be granted for the same “value” as comparable options. Helps with companies that may not have enough available shares to float.

RSU's

- Similar to restricted stock.
- Only difference is timing of exercise. Employee can SOMETIMES elect to defer payment of RSU's until a point which the employee elects and not according to a vesting schedule. This is usually when the employee leaves employment.
- Not taxed upon vesting if deferment is an option
- Taxed as ordinary income when the employee actually receives the stock.
- No opportunity for LTCG treatment except on future gains. (Except if filing an 83B)

How to Obtain Information

- Subpoena the company **or ask for**
 - RSU Plans and all amendments
 - Grant agreements and all amendments
 - Award letters, memorandum or all correspondence (including electronic correspondence) relating to the grant
 - Any documents that indicate the purpose of the grant
 - Summary Plan Descriptions
 - Annual Statement of employee benefits

Cont.

- Any employee manuals that describes the employee's rights to benefits
- Employment contract/letter offering employment
- Beneficiary designation forms
- The employee's entire employment file
- Valuations conducted for IRC Section 409(A) purposes or other purposes
- The employee's Form W-2

Asset or Income

- Most RSUs pay a dividend equivalent on UNVESTED units.
- Some plans accrue that dividend and pay at vesting.
- Get the plan document to be sure.

RSU's in Divorce

- The IRS has confirmed in PLR 201016031 that the division of restricted stock pursuant to a state court divorce decree is a nontaxable event under IRC §1041. The IRS also agreed that the income reported upon vesting of the stock could be divided between the parties, with **the value of stock received by the non-employee spouse being reported as income on a Form 1099-MISC. Although, this ruling did not address the FICA consequences, in Notice 2002-31, the IRS indicated that when nonqualified stock options were transferred pursuant to a divorce order, FICA is payable by the employee on all of the options, including those transferred to the former spouse. A similar result may occur upon vesting of the restricted stock or any RSUs divided in a divorce.** ²

What's that mean?

- The employee can issue a 1099-misc to the ex for the value of the transfer but will STILL be liable for FICA tax from his own wages and should be compensated for that.
- BEWARE: on audit a PLR may NOT hold up! Ask your couple/client/attorney how they want to handle the taxes.

What's Marital

- Hugg Formula – used for options awarded upon hiring due to past performance
- Date of hire(HD) minus date marital efforts end (DS) /Date service began (HD) minus option vesting date (VD)

$$CP = \frac{\text{Number of months between HD and DS}}{\text{Number of months between HD and VD}}$$

What's Marital

- Nelson Formula - Time between grant (GD) and marital separation (DS) / Time between grant (GD) and vesting (VD)
- Used for awards based on future service

$$CP = \frac{\text{Number of months between GD and DS}}{\text{Number of months between GD and VD}}$$

What's Marital

RSU Harrison Calculation v3.xlsx - Excel

FILE HOME INSERT PAGE LAYOUT FORMULAS DATA REVIEW VIEW DEVELOPER QuickBooks

Clipboard Bluetooth Font Alignment Number Styles

Normal Good

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	A	B	C	D	E	F	G	H	I	J	K	L
1	Exhibit A											
2	12/31/2015 Marital Property Calculations											
3												
4	Performance Shares											
5	Awarded for performance in subsequent 3 years.											
6	Released annually based on performance but not guaranteed.											
7	GRANT	Shares	Grant Date (GD)	Date of Separation (DS)	GD/DS MO DIFF	Grant Date (GD)	Vesting Date (VD)	GD/SV MO DIFF				Harrison fraction
8		500	2/19/2013	5/31/2016	39	2/19/2013	12/31/2015	34				39/34
9												
10		502	2/18/2014	5/31/2016	27	2/18/2014	1/1/2017	35				28/36
11		414	2/17/2015	5/31/2016	15	2/17/2015	1/1/2018	35				28/48
12												
13												
14	TOTAL											
15												
16	RSUs - 4 year vesting, 25% per year											
17	Awarded for past performance											
18	Released 25% Annually											
19	GRANT	Shares	Grant Date (GD)	Date of Separation (DS)	GD/DS MO DIFF	Grant Date (GD)	Vesting Date (VD)	GD/SV MO DIFF				Harrison fraction
20		119	2/21/2012	5/31/2016	51	2/21/2012	2/19/2016	48				40/48
21												
22		104	2/19/2013	5/31/2016	39	2/19/2013	2/19/2016	36				28/36
23		104	2/19/2013	5/31/2016	39	2/19/2013	2/17/2017	48				28/48
24												
25		104	2/18/2014	5/31/2016	27	2/18/2014	2/19/2016	24				14/24
26		104	2/18/2014	5/31/2016	27	2/18/2014	2/17/2017	36				14/36
27		104	2/18/2014	5/31/2016	27	2/18/2014	2/20/2018	48				14/48
28												
29		88	2/17/2015	5/31/2016	15	2/17/2015	2/19/2016	12				2/12
30		88	2/17/2015	5/31/2016	15	2/17/2015	2/17/2017	24				2/24

RSU CP calc

READY

What about Taxes?

- Options – if a non-employee spouse is going to get the actual options at vesting, then (s)he would have to have the CASH available to buy shares of the stock. The shares could then be transferred to that spouse and disposed of at their desire.
- If they CAN'T pay cash for the shares, then the exercise will be taxed to the employee spouse if options are non-transferrable.

Taxes on RSUs

- When RSUs vest, they are taxable to EMPLOYEE spouse(unless deferral available), who can 1099-misc to other spouse. But employee must pay FICA. Adjust shares to compensate.
- If shares are then sold in less than one year, any gain from vesting price is ordinary income to seller.

02.24.16 Option Marital Property Calculations															Current Mkt	\$
GRANT	Shares	Shares after 25% tax	Grant Date (GD)	Date of Separation (DS)	GD/DS MO DIFF	Grant Date (GD)	Option Vest (SV)	GD/SV MO DIFF	Harrison fraction	CP%		Shares after 25% tax	=	MP shares	Grant Price	
1000	250	188	1/18/2012	5/31/2015	40	1/18/2012	1/18/2016	48	40/48	83%	x	188	=	156	\$ 36.95	
2000	500	375	01/16/2013	5/31/2015	28	01/16/2013	1/16/2016	36	28/36	78%	x	375	=	292	\$ 53.38	
	500	375	01/16/2013	5/31/2015	28	01/16/2013	1/16/2017	48	28/48	58%	x	375	=	219	\$ 53.38	\$
2000	500	375	03/26/2014	5/31/2015	14	03/26/2014	3/26/2016	24	14/24	58%	x	375	=	219	\$ 78.17	\$
	500	375	03/26/2014	5/31/2015	14	03/26/2014	3/26/2017	36	14/36	39%	x	375	=	146	\$ 78.17	\$
	500	375	03/26/2014	5/31/2015	14	03/26/2014	3/26/2018	48	14/48	29%	x	375	=	109	\$ 78.17	\$
3000	750	563	03/18/2015	5/31/2015	2	03/18/2015	3/18/2016	12	2/12	17%	x	563	=	94	\$ 117.29	\$
	750	563	03/18/2015	5/31/2015	2	03/18/2015	3/18/2017	24	2/24	8%	x	563	=	47	\$ 117.29	\$
	750	563	03/18/2015	5/31/2015	2	03/18/2015	3/18/2018	36	2/26	6%	x	563	=	31	\$ 117.29	\$
	750	563	03/18/2015	5/31/2015	2	03/18/2015	3/18/2019	48	2/48	4%	x	563	=	23	\$ 117.29	\$
TOTAL		4312.5										TOTAL		4313	1336	\$
Nelson/Hugg																

Offsetting tax obligation

Language in Decree

- Employee must provide non-employee with all vesting schedules, statements, exercise options, etc.
- Upon vesting, non-employee spouse must send written request to employee spouse to request action.
- If options, consider constructive trust language.
- Ensure that taxation is covered in decree language and is CLEAR!

Summary

- Be sure to get ALL necessary documents
- Use the proper coverture for marital portion
- Adjust for tax impacts
- Ensure that language of decree is specific and clear.

Questions



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