

The background of the page features a red-to-orange gradient with dark silhouettes of a family walking. There are two adults and two children, all holding hands. The silhouettes are slightly blurred, giving a sense of movement. The text is overlaid on this background.

# A Primer on Executive Compensation in a Colorado Divorce—Part 2

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*This two-part article discusses executive compensation issues in Colorado dissolution of marriage proceedings. Part 1 set forth a multi-step process for characterizing and dividing stock rights such as options, restricted stock, restricted stock units, performance-based awards, and nonqualified deferred compensation. This part 2 addresses limitations on dividing executive compensation awards, looks at tax issues to be aware of when the awards are divided, and analyzes whether the awards are income for support purposes.*

**A**s discussed in part 1 of this article,<sup>1</sup> all marital property in a Colorado dissolution of marriage or legal separation, including executive compensation, must be divided equitably between the parties.<sup>2</sup> Part 1 set forth a three-part process for determining whether an executive compensation award is property, what portion of an award is marital versus separate property, and how to value and allocate the marital portion of the award.

This part 2 addresses limitations on dividing awards, tax considerations to be aware of when allocating awards, and whether and to what extent awards constitute income for support purposes.

#### **A Recap of Executive Compensation**

“Executive compensation” as discussed here refers to benefits typically offered to highly compensated employees, executives, officers, and directors. These benefits focus on providing rewards in exchange for results and vary widely from employer to employer. The awards may be in the form of (1) options, restricted stock units, or restricted stock, which link payouts to increases in stock price; or (2) performance or incentive awards, such as cash or stock rights delivered upon the attainment of certain benchmarks. In addition, nonqualified deferred compensation plans may permit or require employees to defer awards or compensation to a later date.

Qualified deferred compensation plans such as IRC § 401(k) plans or IRC § 401(a) defined benefit pension plans are outside the scope of this article.

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#### **Limitations on Dividing Executive Compensation**

Once an executive compensation award is determined to be marital property, the next step is to allocate the marital portion of the award. As described more fully in part 1, courts

have a number of options when determining whether to value an executive compensation award and how best to allocate it between the parties. Several factors must be addressed when deciding how and when to divide executive compensation.

First, all governing documents must be reviewed to determine whether there are restrictions on transfer before vesting. If an executive compensation award is divisible before vesting, it is preferable to divide the award in kind between the parties. If the award is split equally between the parties, each spouse will share equally in the risk of loss or gain. Equal division in kind also allows the parties to avoid the expense and risk associated with having an award valued. If the award is not split equally between the parties, the award should be valued.

Next, practitioners must familiarize themselves with the statutory and plan limitations on transfer of executive compensation awards. For example, IRC § 409A limits when executive compensation may be distributed. Plans and participants who violate this section face dire consequences: the value of the compensation deferred by each participant under the plan will be included in the participants’ gross income, plus penalties.<sup>3</sup> Needless to say, no employer or plan administrator will permit a distribution in violation of § 409A because a catastrophic plan failure would result. Thus, court orders and mediated settlements must conform with the timing and distribution rules in statutes and plan documents.

Executive compensation plans subject to § 409A may, but are not required to, permit early distribution of benefits to a



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spouse pursuant to a domestic relations order (DRO).<sup>4</sup> A DRO conforms generally with the form required for qualified domestic relations orders that family law practitioners use to divide qualified retirement plan benefits.<sup>5</sup> Practitioners should review the plan documents (including the summary plan description) and award agreement, and consider consulting with the plan administrator to determine whether a DRO may be used to effectuate distribution in divorce. If this option is not available under a given plan, a constructive trust (discussed below) should be put in place to protect the non-employee spouse's share of the award until distribution occurs.

In addition, holders of incentive stock options issued under IRC §§ 421 and 422 cannot transfer the options other than by will or the laws of descent.<sup>6</sup> This transfer limitation will be reflected in the plan documents. Similarly, restricted stock awards cannot be transferred until after vesting occurs. As a result, practitioners must familiarize themselves with governing plan documents and understand whether and to what extent a distribution can be made to the nonemployee spouse at the time of the divorce.

If the plan or a statute prohibits transferring an award until vesting takes place, a constructive

trust may be imposed.<sup>7</sup> Under a constructive trust, the employee spouse continues to own the award until the non-employee spouse's share can be distributed. The employee has a fiduciary duty to manage the non-employee spouse's share of the award with care and in the same manner as the employee spouse manages his or her own share of the award.

#### **Tax Issues Implicated when Allocating Awards**

When a constructive trust is imposed on certain executive compensation awards, the employee spouse will be taxed on the entire award when the award becomes taxable. Where the non-employee spouse's share of the award is taxed to the employee spouse, the non-employee spouse should be required to reimburse the employee spouse for the taxes allocable to the non-employee spouse's share of the award.

Accordingly, understanding when different types of executive compensation will be taxed is an essential part of analyzing this form of property in divorce. Options are taxed differently depending on whether they are incentive stock options or non-statutory stock options. Incentive stock options are taxed when the stock sale occurs, not on the date of the grant or the date of exercise.

Non-statutory stock options are a bit more complicated; those with a readily ascertainable value are taxed as ordinary income at the time of exercise<sup>8</sup> and again, when sold, at capital gain rates.<sup>9</sup> Holders of non-statutory options that do not have a readily ascertainable value are taxed on the fair market value of the stock received at the time of exercise, less the amount paid at exercise.<sup>10</sup>

Under IRC § 83(b), recipients of both non-statutory option awards and restricted stock awards may be eligible to elect to be taxed at the time the stock is sold on the value of the stock determined as of the date of grant.<sup>11</sup> A § 83(b) election affects the tax calculation both for valuation and allocation purposes.

Nonqualified deferred compensation is subject to FICA (Old Age, Survivors, and Disability Insurance and Medicare) and FUTA (federal unemployment tax) payroll taxes.<sup>12</sup> Depending on how the deferred compensation plan is structured and whether the general or special rules apply, FICA and FUTA may be withheld at the time the compensation is deferred into the plan<sup>13</sup> or when the benefits are actually or constructively received.<sup>14</sup> Further, distributions from a deferred compensation plan are considered wages subject to withholding.<sup>15</sup> If the withholding rates of the employee spouse and the non-employee spouse are different, a tax true-up between the parties may be appropriate.

### **Executive Compensation as Income**

The definition of “gross income” for child support and maintenance purposes is broadly inclusive and encompasses income from any source.<sup>16</sup> The few exceptions from gross income include child support, certain public benefits, income from additional jobs in excess of 40 hours per week, certain Social Security benefits, and earnings on retirements accounts not taken as distributions.<sup>17</sup> As a result, for the most part, executive compensation is considered income for support purposes.<sup>18</sup> But deciding whether and when an award is income could be complicated.

### ***The Double Dip***

Colorado law does not directly address “double dipping” in the context of executive compensation in a divorce.<sup>19</sup> Absent any prohibition

on double dipping, executive compensation awards may be characterized both as property to be divided in the divorce and income from which support will be paid. However, Colorado domestic relations courts are courts of equity.

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Therefore, if the employee spouse’s executive compensation awards are divided as part of the marital estate, practitioners may legitimately argue that it is inequitable for the non-employee spouse to receive a portion of the awards in the property division and support based on the same asset.

### ***Unvested Versus Vested Awards***

Income expected to be received from stock awards may also have to be calculated. Currently, there is a dearth of guidance in Colorado on how to perform this calculation for restricted stock or restricted stock unit awards, but several cases address when to include stock options in income for support purposes.

For example, the Court of Appeals has held that where a husband received stock options in return for services and as an incentive for continued employment, and the options vested at 20% per year, his income had to be calculated based on the actual income he realized from the exercise of his options.<sup>20</sup> Similarly, the Court of Appeals has stated that “a spouse’s stock options from an employer are included in gross income for child support purposes only to the extent that the options have already been exercised at the time child support is determined.”<sup>21</sup> In both circumstances, the Court of Appeals’ holdings required the options to be vested and exercised before income could be taken into account for support purposes. Thus, at least with respect to stock options, Colorado courts have declined to include unvested awards in income for support purposes. Similarly, even vested options cannot be included in income until the options are actually exercised.

### ***Income Averaging***

For awards of an unknown amount, such as annual bonuses that vary from year to year, Colorado courts have several options. Where a parent’s income substantially fluctuates, courts may consider past earnings or an average of past earnings when calculating income for support purposes.<sup>22</sup> Courts may follow the same approach where there is conflicting evidence regarding the amount of a parent’s income.<sup>23</sup> Where future bonuses are not guaranteed, it is not an abuse of discretion for courts to decline to estimate the amount of possible future bonuses for present support calculations.<sup>24</sup>

### ***Harmonizing the Treatment of Options and Bonuses***

Colorado treats bonuses and stock options differently because the former may be averaged according to past awards, while the latter cannot

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Statutory and case law along with plan documents guide the characterization of executive compensation awards as property versus mere expectancy and marital versus separate property and provide clear instructions for valuing and dividing awards.

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be included in income for support purposes until the date exercised. In practice, courts may be more comfortable valuing bonuses—which have a historical track record—than stock options, whose valuation requires predicting the stock price in the future.

For example, a court provided with a history of bonuses paid may make an income determination based on facts that have already occurred, finding that, going forward, a sufficient history of regular bonuses justifies the inclusion of a bonus in income for support purposes. Alternatively, the court may decide that the history of bonuses is too short, too varied in amount, or too speculative to support a determination that bonus income should be included for support purposes.

On the other hand, a court attempting to predict the future net income a party could receive from the exercise of existing stock options faces several additional complicating factors. The court has no way to predict (1) when the options will be exercised, (2) the price of the underlying stock on the date of exercise,<sup>25</sup> or (3) whether there will be future options awards and, if so, what the date of grant price will be.<sup>26</sup>

That said, the practice of projecting income by averaging historical bonuses can be applied to stock options where the court averages a party's income received from past exercises of stock options instead of attempting to predict future

income from options that have not yet been exercised. In this determination, a judge would be expected to consider the historical volatility of the stock price and whether unexercised option awards exist. If no unexercised awards or guaranteed future awards exist when a judge makes an income determination, including past income from the exercise of options in income for support purposes would likely be unwarranted.

#### *Deferred Compensation*

Colorado excludes from income contributions to an unfunded deferred compensation plan, where the participant does not voluntarily make such contributions, has no control over the funds, and cannot withdraw funds until after retirement.<sup>27</sup>

Where the participant is not required to defer compensation, but may elect deferral, guidance is scarce in Colorado. The simplest argument is that deferred compensation is income for support purposes when it is included in the participant's income for tax purposes. Deferred compensation plans are intentionally drafted to avoid taxation on the amounts deferred until the date of distribution. It would be rare to find deferrals being made into such a plan after constructive receipt of the compensation, since to do so would negate the tax benefit to the participants.

However, it is possible to imagine the owner-spouse of a closely held company putting a defective deferred compensation plan in place to shield income from inclusion for support purposes. Practitioners concerned about this sort of abuse should look at whether the plan is funded or unfunded, whether the deferral election was made during the pendency of the dissolution or legal separation action, whether the participant has any power to accelerate receipt of the funds once deferred under the plan, and the timing of distributions from the plan. If the terms of a deferred compensation plan do not effectively defer compensation for tax purposes, further investigation is warranted.

#### **Conclusion**

The complexities associated with dividing executive compensation in a Colorado divorce are not insurmountable obstacles. Statutory and case law along with plan documents guide the characterization of executive compensation awards as property versus mere expectancy and marital versus separate property, and they provide clear instructions for valuing and dividing awards. But practitioners must thoroughly understand restrictions on the distribution of executive compensation before vesting, tax issues, and whether executive compensation is treated as income for support purposes to properly address executive compensation in divorces. **CL**



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## NOTES

1. Wells et al., “A Primer on Executive Compensation in a Colorado Divorce—Part 1,” 51 *Colo. Law.* 26 (May 2022), <https://cl.cobar.org/features/a-primer-on-executive-compensation-in-a-colorado-divorce-part-1>.
2. CRS § 14-10-113.
3. 26 USC § 409A(a)(1)(A)(i)(I) and (II).
4. Treas. Reg. § 1.409A-3(j)(4)(ii).
5. *Id.*
6. 26 USC § 422(b)(5). Aside from the limitations described in IRC § 409A, there are no IRC restrictions on the transfer of non-statutory stock options, to a spouse or otherwise, but the plan document or award agreement may prohibit transfer.
7. *Weeks v. Esch*, 568 P.2d 494 (Colo.App. 1977) (holding that court imposition of a constructive trust in a domestic dispute was proper).
8. 26 USC § 83(a).
9. *Id.*
10. *Id.*
11. 26 USC § 83(b).
12. Rev. Rule 2004-60.
13. 26 USC § 3121(v)(2)(A).
14. Treas. Reg. § 31.3121(v)(2)-1(a)(1).
15. 26 USC § 3401(a).
16. CRS §§ 14-10-114(8)(c)(I) and -115(5)(a)(I). The definition of “gross income” includes income from any source, including salaries; wages (including tips); commissions; independent contractor payments; bonuses; dividends; severance pay; pension payments and retirement benefits actually received; royalties; rents; interest; trust income and distributions; annuity payments; capital gains; monies drawn by a self-employed individual for personal use that are deducted as a business expense; Social Security benefits; workers’ compensation benefits; unemployment and disability insurance benefits; health, accident, disability, or casualty insurance benefits replacing wages, or in lieu of wages; monetary gifts and prizes; income from general and limited partnerships, closely held corporations, and limited liability companies; expense reimbursements or in-kind payments; court-ordered alimony or maintenance received pursuant to a court order; and overtime pay required by the employer as a condition of employment.
17. CRS §§ 14-10-114(8)(c)(II) and -115(5)(a)(II).
18. Executive compensation paid to a non-employee director may fall within the exception for income earned from a second job in excess of 40 hours per week where the director is employed full time elsewhere.
19. There is, however, case law in Colorado permitting valuation and division of goodwill in a business based on historical earnings and awarding maintenance based on the same income, which is arguably a double dip, though the Colorado Court of Appeals declined to recognize it as such. *In re Marriage of Bookout*, 833 P.2d 800 (Colo.App. 1991).
20. *In re Marriage of Campbell*, 905 P.2d 19, 20 (Colo.App. 1995).
21. *In re Marriage of Davis and Nguyen*, 252 P.3d 530, 535 (Colo.App. 2011).
22. *In re Marriage of Rice and Foutch*, 987 P.2d 947 (Colo.App. 1999).
23. *In re Marriage of Salby*, 126 P.3d 291 (Colo.App. 2005); *In re Marriage of Hannum*, 796 P.2d 57, 59 (Colo.App. 1990).
24. *In re Marriage of Finer*, 920 P.2d 325, 329 (Colo.App. 1996).

25. If the price of the underlying stock on the date of exercise is unknown, the amount of income is unknown.
26. If the price of the underlying stock on the date of grant is unknown, the amount of income is unknown.
27. *In re N.J.C.*, 467 P.3d 1209, 1214 (Colo.App. 2019).

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