

## CHAPTER 3

# Complex Compensation Issues in a Divorce

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### INTRODUCTION

Divorce is seldom a happy event. Emotions run high, especially when there is a lot of money at stake. After all, deciding on alimony and child support affects multiple lives for years to come. A cornerstone of this process is the identification and subsequent evaluation of assets and available income stream. Since many individuals are compensated with both wage and non-wage benefits, getting a final number can be time-consuming, arduous, and often requires the help of outside experts.

Three factors explain the challenge of assessing marital monies. First, organizations offer all sorts of benefits and terms can vary across employers. This is a consideration when trying to project future expected income and the value of non-wage benefits for an individual who is likely to change employers later on. Benefit amounts are often linked to the number of years with a company, job performance and/or financial health of the employer. Second, information about benefits may be hard to come by or difficult to interpret when it is available. Third, income may be unreported or overlooked and stay that way without the help of a forensic specialist.

The topic of compensation is broad. Entire books are written on the topic. What this article provides is an overview of compensation issues, a dis-

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cussion of various types of compensation arrangements, information about data sources, and implications for financial planning and valuation, respectively.

## OVERVIEW

Compensation arrangements are frequently classified by work status. Available benefits for a salaried employee can differ radically from those that accrue to a senior executive who has control over plan design, timing and amounts.<sup>1</sup> Closely-held firms enjoy a certain amount of flexibility in designing compensation plans for two reasons. First, they do not face the same accounting and tax rules. Secondly, public companies tend to be larger than many private firms. Benefits for big organizations have to reflect the often more diverse nature of the employee base in terms of job titles and a more structured human resources hierarchy of decision-makers.

If a spouse is a member of a union, benefits can be more or less generous than those offered to non-union employees of the same company. Compensation for self-employed persons can be radically different from wage earners and depends on the life cycle stage of both the company and the related industry. Someone might be a limited or general partner of a firm. Not everyone works in the business sector. For example, some individuals work for non-profit organizations. Others work for federal or state government agencies or perhaps are employed by the U.S. military. In each and every case, both wages and non-wage compensation will reflect the accepted practices for that type of employment situation.

Exhibits 1 and 2 illustrate the breakdown of compensation arrangements for a public company executive and private company business owner, respectively. While the executive of a public corporation will likely enjoy stock option awards and/or restricted stock grants, these benefits are not available to someone who works for a university or any other organization that does not fund operations by issuing common equity. For the business owner, wages may differ from market norms. The owner of a start-up could accept lower than normal wages in order to finance future expansion. On the other hand, wages and benefits for the owner of a mature company

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<sup>1</sup> Executives generally have a greater need to manage tax liabilities. This means that benefit programs they help to create (or perhaps just influence) will not necessarily satisfy financial goals of non-executive employees.

may exceed typical payouts or take the form of excessive travel and entertainment expenses.<sup>2</sup> Either way, a business appraiser will look long and hard at company owner compensation when valuing full or partial ownership in a firm.

**Exhibit 1**  
**Sample Benefit Array for Public Company Officer**

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- Zero or low interest loans
  - Executive stock options
  - Restricted stock
  - Deferred compensation
  - Profit sharing
  - Defined benefit pension plans
  - Defined contribution pension plans
  - Insurance: disability, health, life
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**Exhibit 2**  
**Some Value Sources for Business Owner**

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- Officer compensation
  - Pension plan benefits
  - Perquisites
  - Buy-sell agreement
  - Non-compete agreements
  - Key man life insurance policy
  - Franchise value
  - Distribution rights
  - Personal goodwill
  - Professional goodwill
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<sup>2</sup> The term "value" means different things to different people. When an appraiser is hired to value any business interest, a standard of value is agreed upon at the outset. A common standard of value is "fair market value" which assumes a willing and informed hypothetical buyer and seller.

## VALUATION ISSUES

Notwithstanding the notion that compensation arrangements can and often do vary by industry and organizational form, a cookie-cutter approach is ill-advised for purposes of valuing benefits for similarly titled individuals. Stock options owned by managers who work for private companies have a greater value if the probability of that company going public sometime soon is high.<sup>3</sup> Even then, marketability is an issue. Options issued by private companies are frequently much less liquid than options issued by public companies. This reduces their value. Furthermore, the marketability of options issued by public companies can vary too since some stocks trade infrequently. Subsidized loans are another case where valuation is directly determined by the detailed terms associated with the borrowing. Two executives at the same company can take out loans but the amounts, repayment requirements, rates, and restrictions on loan purpose can vary. The value of loan privileges is higher for someone who can borrow a large amount of money at an interest-free rate with a long time to repay the loan, if repayment is required at all.

Some companies allow higher ranking executives to craft their own compensation benefits, thereby empowering senior-level talent to pick things that coincide with their age or lifestyle, or allow them to take greater risks if they so desire. With self-directed choices, however, not every executive is on the same page and this can result in different paychecks for different executives. "Senior executives of Fortune 100 companies have the opportunity to participate in numerous plans. The financial planner, working with these executives, is challenged to identify and understand the key characteristics of each plan and how the employee can use these plans to achieve maximum financial security. ... It is common for senior executives to have 6 to 12 corporate plans simultaneously, each governed by different rules, growing at different rates and with different levels of contributions. The culmination of these plans can often account for one-third to two-thirds of an executive's annual compensation."<sup>4</sup> This choice factor likewise makes it impossible to generalize about executive benefits. By extension,

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<sup>3</sup> There are many factors that determine the value of employee stock options. "Model Risk and Valuation" by Susan M. Mangiero (*Valuation Strategies*, March/April 2003 issue) provides an overview.

<sup>4</sup> "The Key to Working with Senior Executives: Understanding Corporate Plans" by Brett A. Coffman, CFP®, *Journal of Financial Planning*, October 2003.

valuing these benefits requires a clear understanding of the salient details that characterize executive benefits, not the least of which is the tax status of current and deferred income.

Business owners are a different story altogether, principally when they hold a majority stake and therefore have control over asset disposition, earnings stability, and dividend payments. As stated earlier, a founder might take a lower salary in the early years to ensure that adequate funds are available to fuel company growth. In other situations, owners can blur the line between personal and corporate benefits, compounding the problem of recognizing, and then analyzing, an individual's income and assets.

Divorce cases may require a departure from the fair market value standard to focus instead on the unique value of a company to the husband or wife.<sup>5</sup> This can occur when earnings from a business will be the primary source of funds for alimony and child support. State laws determine the standard of fair value, a standard that is often used in divorce cases in lieu of fair market value. Some laws seek to eliminate "double-dipping" so that the business value is considered only once. Other states ignore this concept. To illustrate, some states first require the valuation of a professional license or business, after which excess earnings over that value are computed for purposes of determining support capacity. Elsewhere, the business is valued as an available asset at the same time that the cash flow generated by the business is looked to for support purposes.

Generally speaking, anyone who fails to recognize the link between total compensation and work status – and the related impact on valuation – does a disservice to their client since amounts, timing, and likelihood of realizing income vary by employer and employer type. This is particularly true in recent years as the corporate benefit landscape continues to shift in response to economic pressures, new laws, altered demographics, and public outcry over excessive paychecks that do little to promote shareholder wealth creation. Even middle managers and blue-collar workers are affected as companies find it increasingly impossible to fund expensive promises and stay in business.<sup>6</sup>

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<sup>5</sup> The standard of fair market value assumes a hypothetical, willing, and informed buyer and seller. This can differ from estimating value for a specific individual who has a particular reason for buying or selling an asset or entire business – i.e. keeping something in the family, tax reasons, gaining market share, etc.

<sup>6</sup> Byrnes, Nanette with David Welch, "The Benefits Trap", *Business Week*, July 19, 2004

Movement is afoot elsewhere as well. Municipalities are scaling back benefits to keep the tax burden in check. Union members regularly swap benefits for job security. This rapid change in the way people are paid directly influences estimates of future expected cash flow. This is particularly apropos for divorce cases that involve the long-range projection of earnings and cash flow, based in part on the current wage and non-wage benefit structure in place.

### INFORMATION IS EVERYTHING

Two situations create problems. The first is having too little information about total compensation. The second is having too much information. Neither is ideal. When too little information is available, the financial professional must identify what is missing and seek it out. This can be challenging. For one thing, the information may simply not exist. Alternatively, it may exist but in a form that is difficult to rely on with confidence. For example, audited company statements can provide a lot more comfort to the user than those that are not audited. Yet even with audited statements, adjustments may be required to normalize financial data. This happens regularly with the appraisal of business interests. Owner compensation may be adjusted downward as part of the valuation analysis if competitors regularly pay lower amounts to managers. Automobiles or planes may be removed from the balance sheet if their use adds little to business earnings. Old inventory could be removed altogether if future use is unlikely in generating sales. These adjustments and many others permit a better assessment of the company's worth, a precursor to any divorce settlement that involves a spouse who owns all or part of a company.

The flip side is being deluged with information and not knowing the right way to sift through the details. Since many organizations offer an abundance of benefits from which the employee can choose, this outcome is not far removed from reality. Information is typically available for each benefit, either in brochure form or aggregated in a huge employee benefits handbook. A financial person may end up having to read about sponsor-provided pension plans, employee stock options, a variety of investment choices, insurance benefits and other perquisites such as education-related refunds, automobiles, health club memberships, interest-free loans, to name a few.

Even when such assets are easy to identify, the financial professional must know which questions to ask in order to properly assess income and adjust financial statements accordingly. When left undone, the result is an improper assessment of existing and estimated future earnings as well as a flawed picture of both historical and sustainable lifestyle. Deferred compensation is a case in point.

The tasks for understanding these benefits, available to highly compensated individuals, include financial discovery, reconciliation of reported income with actual cash flow, the unraveling of personal and business expenses, and the creation of a time line that lays out planned future accruals. Depending upon the employer's policies and IRS rules, these benefits may be transferable to an ex-spouse in the event of divorce; but many are not. Ferreting out information about "non-wage" benefits is hard work.

It is incumbent upon the financial professional brought in by the wife or husband to organize, gather and analyze all pertinent financial information. (Sometimes the mediator hires the financial planner and/or appraiser.) The objectives are threefold: 1) understand the client's historical lifestyle as a married couple, 2) interpret changes in their lifestyle during the divorce, and 3) project their needs on a post-divorce basis. Not surprisingly, this lifestyle analysis frequently provides more insight about available resources than an examination of official income reports. With wage earners, information is more readily available since the employer provides reportable income.

Information gathering is more problematic in the case of business ownership. As stated before, compensation may differ widely from accepted industry norms. An owner may expense items that relate to personal enjoyment and are not properly included as part of corporate financials. Moreover, an appraiser must be careful to distinguish business value from individual earnings.

Exhibit 3 lists some good places to find information, a precursor to the reconciliation of reported gross income with actual cash flow. Importantly, information gathering should take place at the time of the divorce, along with every year thereafter that defines the settlement period. In reality, the burden of disclosure is borne by the non-employee spouse, especially in the case of an acrimonious split.

**Exhibit 3**  
**Some Sources of Financial Information**

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- Personal & business income tax returns
  - Limited partnership reports
  - K-1 reports and underlying pages of detail
  - Social security wages report
  - Employee contracts
  - Bonus letters
  - Company insider stock transactions
  - Direct deposit slips to employee's accounts (savings, broker)
  - Deferred compensation benefit statements
  - Retirement plan statements including summary plan description
  - Payment of personal items by business (travel, entertainment)
  - Subscription receipts
  - Memberships dues slips
  - Telephone account documents
  - Company bank account statements
  - Custodial accounts reports
  - Trust documents
  - Employee loan forms (indicated on pay stubs)
  - Employee dividend reinvestment program reports
  - Tax loss carryforward reports
  - Margin loan information
  - Company by-laws
  - Buy-sell agreements
  - Key man life insurance policy
  - Foreign bank account statements
  - Personal financial software files
  - Company financial software files
  - Travel itineraries
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Sometimes, the non-employee spouse may be persuaded to offset his or her right to share in benefits by accepting other more tangible assets at the time of settlement. The reasons for offset are many but tend to focus on the goal of shielding the non-employee spouse from the uncertainty surrounding the valuation of future benefits. In this regard, many non-employee spouses consciously forgo upside potential gains from various benefit items based on conservative legal advice and their frequent need for immediate liquidity.

An additional consideration is the cost of having complex benefits appraised versus accepting real assets such as the marital residence, collectibles, or bank accounts. This posture may be appropriate in some cases but should not be based on less than full knowledge of the estimated value of such benefits. (Ironically, this estimate itself often requires the services of a professional appraiser.) Lastly, there is the emotional factor of staying tied to your ex-spouse in future years in order to enjoy one's legal claim when these benefits become available. Many non-employee ex-spouses are simply not up to the task of tracking the calendar or their ex-spouse's whereabouts to fulfill their entitlement to these benefits.

## OTHER INCOME

A review of income tax returns is necessary but insufficient to fully understand what is at stake. Social security wage reports, pay stubs, and bank account statements help but are only a start. Ignoring all available and salient information can have dire consequences.

Consider Joe Smith. Income reports substantiate a consistently large salary. At the same time, the bank reports high credit card debt, repeated credit card advances, and a negative cash balance in the family checking account. The few marital assets that exist are hard to liquidate without incurring high fees. His wife, Sally, requests that generous support be awarded and points to income as the source, failing to take into account the marketability issue and the irregularity of available cash flows. Income information alone misses the mark. It says nothing about stock grants or option amounts, the tax status of existing benefits, cash flow requirements associated with transactions such as stock buys, and a bevy of other items.

Once other income is identified, the financial planner needs to look at regularity, predictability and amount. It is also necessary to understand the employer's contractual arrangements with the employee that dictate vesting rules, lock-out or black-out provisions, deferral issues, and anything else that limits the employee's ability to earn a living going forward.

### ASSETS ARE IMPORTANT TOO

It takes significant time to become practiced in understanding a company's plans. Forging a relationship with a company's benefit manager is time well spent, especially if a large employer dominates the local economic scene. This person can provide invaluable information about whether and how often an employee can elect to change the benefit mix, tax issues, and related asset allocation issues. Beyond that, the financial professional must know whether and how an employee or business owner has hedged away financial risks.<sup>7</sup> Exhibit 4 is a checklist of action steps for anyone seeking a better understanding of an individual's asset base.

#### **Exhibit 4** **Asset Valuation Checklist**

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- Identify tangible assets.
  - Identify intangible assets.
  - Determine asset transferability rules.
  - Assess liquidity of assets.
  - Determine whether, how and if assets are likely to be forfeited.
  - Evaluate whether assets can be hedged.
  - If hedged, assess the risk-return characteristics of the hedge.
  - Identify the tax consequences of transferring assets.
  - Determine whether a spouse can cherry pick assets.
  - Evaluate which assets can be offset against each other.
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<sup>7</sup> Hedging transfers financial risk to a third party. Knowing exact details about the structure of the hedge is the only way to understand how the employee's risk position changes.

An appraiser is often hired to provide an independent opinion of value for both tangible and intangible assets. Sometimes each spouse hires his or her own appraiser. Users may vary. It could be each respective attorney, a mediator, and/or the judge. Some assets are easier to value than others because a ready market already exists. Exhibit 5 lists some of the many items an appraiser could be called in to value.<sup>8</sup> Valuations are done for a host of reasons, not the least of which is determining worth for a divorce settlement.

#### **Exhibit 5** **Some Items that Appraisers Value**

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- Art
  - Business goodwill, if applicable
  - Coins
  - Copyrights
  - Majority ownership interest
  - Minority ownership interest
  - Non-compete agreements
  - Patents
  - Personal goodwill, if applicable
  - Real estate
  - Restricted stock
  - Stock options
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On a related note, hiring an appraiser can be a worthwhile exercise when putting together a pre-nuptial agreement, especially if an individual has been married before and already has children.

#### **SUMMARY**

Whether for financial planning or valuation purposes, understanding income and assets is critical to the divorce process. Many times, an attor-

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<sup>8</sup> A business appraiser renders an independent opinion of value for business interests. Examples include, but are not limited to, employee stock options, restricted stock, patents, or minority (majority) ownership stake in a closely held company. Tangible asset specialists handle real estate, art, and machinery valuation.

ney will bring in both an appraiser and a financial planner because each person plays a unique role in determining what is available for distribution to the divorcing spouses. While a financial planner and appraiser each provide different services, they share some common responsibilities such as: 1) gathering information, 2) asking tough questions, 3) analyzing data, and 4) providing results to their client.<sup>9</sup>

The benefits landscape is already complex and unlikely to become any less so in the future. Add to that the vagaries specific to divorce and it is clear that specialists can provide some valuable help.

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<sup>9</sup> Sometimes a divorce case requires the use of a forensic professional who can determine whether assets or income are missing or hidden on purpose. Importantly, the forensic work is done by someone other than the appraiser for many reasons, including the avoidance of conflict of interest.

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