

Characterization: 401k Plans, Pensions, Stock Options, Restricted Stock

“A House Divided” Property Division Seminar - April 29, 2014

by Greg Enos

1. Game Changer: a pre-marital or post-marital property agreement can completely change the characterization analysis of a retirement plan. Most property agreements state that all of a spouse’s retirement is his or her separate property. The analysis below assumes there is no marital property agreement.

2. Characterization of Retirement Plans - Note that different pension calculations apply for divorces filed before September 1, 2009 because of the repealed Sec. 3.007 (a) (b), which were repealed by the 2009 Legislature for suits filed on and after September 1, 2009.

3. Traditional Pensions - (defined benefit plan)

For traditional pensions, a mathematical formula has to be applied to determine how much is community property. If benefits are matured (in pay status or eligible to be paid), the *Taggart v. Taggart*, 552 S.W.2d 422 (Tex.1977) formula applies:

$$\text{community portion} = \frac{\text{\# of months married during employment}}{\text{total \# of months of employment}}$$

If benefits are not fully matured, the *Berry v. Berry*, 647 S.W.2d 945 (Tex. 1983) formula applies:

$$\text{community portion} = \frac{\text{\# of months married during employment}}{\text{\# of months of worked at time of divorce}} \times \text{(monthly benefit that employee would have received at divorce date, whether then eligible to retire or not)}$$

The *Berry* formula involves a fraction that is multiplied by the monthly benefit that employee would have received at divorce date, whether then eligible to retire or not. *Gainous v. Gainous*, 219 S.W.3d 97, 109 (Tex. App.—Houston [1st Dist.] 2006, pet. denied). This mythical value is called the “vested accrued benefit,” which refers to the amount of benefits that a participant has earned under a defined benefits pension plan as of any particular date and is usually stated in terms of a monthly pension amount. It is generally based on the employee's years of service with the company and his/her final average compensation as of the calculation date.

For example, the ExxonMobil pension calculates monthly retirement pay as follows: 1.6% x years of employment x the highest average of 36 consecutive months of pay during the last 10 years of employment. If the employee is 34 years old and has worked 11 years for ExxonMobil at the time of divorce, he or she is not eligible to retire and will continue to increase the pension amount by working after the divorce. The *Berry* formula would require the ExxonMobil pension plan to calculate what the employee would have received in a monthly pension at the time of divorce and award the other spouse his or her share of that amount. When the ExxonMobil employee finally does retire, he or she would get the full amount based on the pension equation less the amount awarded to the ex-spouse as of the time of divorce.

4. Cash Balance Pension - the community portion should be the amount the balance increased during the marriage.

5. Cost of Living Adjustments (COLAs) - a pension plan provides for annual increases to keep up with inflation. Generally, some part of COLAs will be community property. *Phillips v. Parrish*, 814 S.W.2d 501, 505 (Tex. App.—

Houston [1st Dist.] 1991, writ denied); *Stavinoha v. Stavinoha*, 126 S.W.3d 604,612 (Tex. App.—Houston [14th dist.] 2004, no pet.). The court can award a percentage of postdivorce COLAs as community property. *Sutherland v. Cobern*, 843 S.W.2d 127, 132 (Tex. App.—Texarkana 1992, writ denied).

6. Defined Contribution Plans (401k, Simple IRA, 403b, etc.)

Often, the separate property portion of a 401k or other defined contribution plan is the balance as of the date of marriage, but it depends on how the plan account is invested.

Tex. Family Code §3.007(c) states:

The separate property interest of a spouse in a defined contribution retirement plan may be traced using the tracing and characterization principles that apply to a nonretirement asset.

In other words, apply the usual rules for characterization, such as the doctrine of inception of title, tracing rules, etc. So, funds in the plan prior to marriage (if proven) would be separate property. Funds added to the plan during the marriage through employee contributions, employer matches, interest and/or dividends would be community property.

However, the attorney must check to see what the employee's plan account is invested in now compared to its investments at the time of marriage. Most are invested in mutual funds or cash, but some plan accounts are invested in individual stocks (often shares of the employing company). The general principle that applies is this: if you own a property before marriage it is separate and if that property increases in value during the marriage the entire increased value remains separate (such as a painting valued at \$5,000 at marriage but at \$100,000 at divorce - the entire \$100,000 is separate property). If the 401k plan holds the exact same investment (100 shares or 622 units of the same mutual fund), that investment would still be all separate property even if its value has increased during the marriage.

Example: At marriage, the 401k has \$40,000, of which \$10,000 is in a money market account and \$30,000 is invested in company stock (1,000 shares at \$30 per share.) Eight years later at divorce, the 401k is worth \$110,000 but the account still holds the same 1,000 shares that are now worth \$50 each. So, the separate property portion of the 401k is \$60,000 (\$10,000 in cash at time of marriage plus \$50,000 in stock).

7. Military Retirement - This is a very complicated issue and attorneys need to consult with texts or experts on military retirement. *Caracciolo v. Caracciolo*, 251 S.W.3d 568, 572 - 3 (Tex. App.—San Antonio 2007, no pet.) provides an example of calculating the 50% of military retirement awarded a wife while the husband was still on active duty:

Anthony testified that he retired under the "high 36" plan, which was his only retirement option under federal law. He testified that under this plan, he first had to average the last 36 months of his base pay as the base line for calculating his retirement pay. He further testified that based upon his pay statements, at the time of the divorce his average base pay during the 36 months preceding his divorce was \$2,241.61. He multiplied this amount by a percentage derived from the number of years he served times 2.5. Since he had served in the military for 17.5 years at the time of divorce, the result was 44%. He thus multiplied \$2,241.61 by 44%, computing a total of \$986.30. To determine Joanne's share, he divided this amount in half as required by the divorce decree, which equaled \$493.15. He rounded this figure up to \$494.

8. Stock Options and Restricted Stock - One very valuable type of employee benefit some higher level corporate managers receive is Restricted Stock. An award of Restricted Stock is a grant of company stock in which the recipient's rights in the stock are restricted until the shares vest. The restricted period is called a vesting period. Once the vesting requirements are met, an employee owns the shares outright and may treat them as she would any other share of stock that she owns.

An example would be Sally Smith, a plant manager for Exxonmobil. Exxon wants to reward Sally for her valuable work and also give her a strong incentive to stay with the company. So, the company grants Sally Smith 1500 shares, which vest in four years. If Sally stays with the company for four years, then she is the owner of 1500 shares of company stock. If she quits or is fired before the shares vest in four years, she does not get the stock. Unlike stock options, which are valuable to the employee only if the stock exceeds some set price in the future, an award of restricted stock has value even if the company's stock has gone down. Once Sally Smith vests, she gets her stock and can hold on to it or sell it at whatever Exxon shares are worth at the time.

Some awards of restricted stock are granted in tranches or groups. For example, Tom Green might be awarded 800 shares of restricted stock, which vest in groups of 200 shares each year, which might look like this:

Award No.	Award Date	No. of shares	Vest date
HCG0402113	3/8/2010	200	3/8/2011
HCG0402113	3/8/2010	200	3/8/2012
HCG0402113	3/8/2010	200	3/8/2013
HCG0402113	3/8/2010	200	3/8/2014

A. How do Restricted Stock Award Plans work?

Once an employee is granted a Restricted Stock Award, the employee must decide whether to accept or decline the grant. After accepting a grant, the employee must wait until the grant vests. Vesting periods for Restricted Stock Awards are usually time-based (a stated period from the grant date), but occasionally are performance-based (often tied to achievement of corporate goals.)

When a Restricted Stock Award vests, the employee receives the shares of company stock or the cash equivalent (depending on the company's plan rules) without restriction.

If an employee's restricted stock pays dividends, the employee receives the dividend payments, even if the shares have not yet vested. The dividends are considered income, so the employee will be taxed at his or her ordinary income tax rate, not the lower 15% rate (unless an 83(b) election has been made). Under the current tax code, once the stock vests, dividends will be taxed at the lower 15% rate.

An employee who accepts an award of restricted stock receives voting rights based on those shares immediately, even before the shares vest.

B. Restricted Stock Units (RSU's)

An award of Restricted Stock Units is a promise of stock that will be issued to the employee in the future at no cost (or at a nominal cost, such as \$.01 per share) provided that the employee meets the vesting requirement. As with Restrict Stocked, the vesting requirement is usually a number of years the employee must remain with the company but sometimes is tied to company performance. Because there is no underlying stock at the time of grant--just a unit that represents the value of the company's stock (e.g. one unit = five shares of stock) – the employee does not have voting rights and usually does not receive dividends on the units. Once the units have vested, they are converted into stock, which is then released to the employee. Usually, the employee will have to pay withholding taxes when the units are converted to stock or a cash equivalent and the employer will not release the shares (or cash) to the employee until taxes have been paid.

Some RSU plans allow the employee to defer receipt of the stock to a future date, such as retirement.

Generally, restrict stock units are taxed as income when they are distributed as stocks or cash whereas a restricted stock award is taxed upon vesting, even if the shares have not been sold.

C. Documents Needed in a Divorce Regarding Restricted Stock and Restricted Stock Units

The attorneys on both sides of a divorce case should obtain the following documents regarding restricted stock/stock units owned by either spouse:

1. A copy of the letter from the employer granting the restricted stock/units to the employee.
2. The vesting schedule for the restricted stock/units, which shows the date of the award, the amount of shares/units awarded and the vesting date. Most employers use a brokerage company like Morgan Stanley or Fidelity to hold the restricted stock for the employee, and so often this information comes from the brokerage company that holds the restricted stock. Larger companies, such as ExxonMobil provide this information and employees can login into their personal benefits account and print their vesting schedules.
3. A copy of the employer’s restricted stock benefit plan. Some small employers may not have a plan description - it may all be in the letter which granted the stock award. The lawyer must determine early in the case whether the plan or employer allows restricted stock to be awarded in a divorce.
4. Contact information for the company which administers the restricted stock plan and the employee’s account number.

D. How to Determine Whether Restricted Stock and RSU’s Are Community or Separate Property?

The following chart summarizes when restricted stock/units are considered separate or community property in Texas:

Awarded before marriage	Vested before marriage	All separate property
	Vested during marriage	Part community and part separate - see formulas below
	Vested after divorce	Part community and part separate - see formulas below
Awarded during marriage	Vested during marriage	All community property
	Vested after divorce	Part community and part separate - see formulas below

The Texas Family Code explains how to calculate how much of a restrict stock award is separate property. Section 3.007 states:

Sec. 3.007. PROPERTY INTEREST IN CERTAIN EMPLOYEE BENEFITS.

(d) A spouse who is a participant in an employer-provided stock option plan or an employer-provided restricted stock plan has a separate property interest in the options or restricted stock granted to the spouse under the plan as follows:

- (1) if the option or stock was granted to the spouse before marriage but required continued employment during marriage before the grant could be exercised or the restriction removed, the spouse's separate property interest is equal to the fraction of the option or restricted stock in which:*

(A) the numerator is the sum of:

- (i) the period from the date the option or stock was granted until the date of marriage; and*

(ii) if the option or stock also required continued employment following the date of dissolution of the marriage before the grant could be exercised or the restriction removed, the period from the date of dissolution of the marriage until the date the grant could be exercised or the restriction removed; and
(B) the denominator is the period from the date the option or stock was granted until the date the grant could be exercised or the restriction removed; and

(2) if the option or stock was granted to the spouse during the marriage but required continued employment following the date of dissolution of the marriage before the grant could be exercised or the restriction removed, the spouse's separate property interest is equal to the fraction of the option or restricted stock in which:

(A) the numerator is the period from the date of dissolution of the marriage until the date the grant could be exercised or the restriction removed; and

(B) the denominator is the period from the date the option or stock was granted until the date the grant could be exercised or the restriction removed.

(e) The computation described by Subsection (d) applies to each component of the benefit requiring varying periods of employment before the grant could be exercised or the restriction removed.

Based on Sec. 3.007 quoted above, the formulas used to calculate how much of restricted stock is separate property are as follows:

Awarded before marriage, but vests during marriage

Separate property percentage = $\frac{\text{\# of months between award date and marriage date}}{\text{\# of months between award date and date of vesting}}$

Example: Restricted stock awarded on 2/1/2010
 Married on 8/1/2011
 Stock vests on 2/1/2014

$\frac{\text{\# of months between award date and date of marriage: 18 months}}{\text{\# of months between award date and date of vesting: 48 months}}$

Separate property percent = 18 divided by 48 or 37.5%

So, if 210 shares were awarded, then 78.75 shares are separate and 131.25 shares are community property.

Awarded before marriage but vests after the date of divorce

This formula would only apply to a short marriage, since restricted stock usually involve vesting periods of four years or less.

$$\text{Separate property percentage} = \frac{\begin{aligned} &\# \text{ of months between award date and marriage date} \\ &+ \\ &\underline{\# \text{ of months between divorce date and vesting date}} \\ &\# \text{ of months between award date and date of vesting} \end{aligned}}{\# \text{ of months between award date and date of vesting}}$$

Example: Restricted stock awarded on 2/1/2010
 Married on 8/1/2010
 Divorced on 11/1/2012
 Stock vests on 2/1/2014

$$\begin{aligned} &\# \text{ of months between award date and date of marriage: } 6 \text{ months} \\ &+ \\ &\underline{\# \text{ of months between date of divorce and vesting date: } 15 \text{ months}} \\ &\# \text{ of months between award date and date of vesting: } 48 \text{ months} \end{aligned}$$

Separate property percent = 21 divided by 48 or 43.75%
So, if 210 shares were awarded, then 91.875 shares are separate property.

Awarded during the marriage but vests after the date of divorce

$$\text{Separate property percentage} = \frac{\begin{aligned} &\underline{\# \text{ of months between divorce date and vesting date}} \\ &\# \text{ of months between award date and date of vesting} \end{aligned}}{\# \text{ of months between award date and date of vesting}}$$

Example: Restricted stock awarded on 2/1/2010
 Married in 1993 before award date
 Divorced on 6/1/2012
 Stock vests on 2/1/2014

$$\begin{aligned} &\underline{\# \text{ of months between date of divorce and vesting date: } 20 \text{ months}} \\ &\# \text{ of months between award date and date of vesting: } 48 \text{ months} \end{aligned}$$

Separate property percent = 20 divided by 48 or 41.66%
So, if 210 shares were awarded, then 87.50 shares are separate property.

The formulas above are expressed in months because that is often the easiest to calculate but it can be done by the number of days. A spreadsheet can be set up to calculate the number of days between two dates.