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Deferred Comp May Offer Way Around Nondeductible Alimony

By **Amy Lee Rosen**

Law360 (March 25, 2019, 7:34 PM EDT) -- While the 2017 tax overhaul eliminated the deductibility of alimony payments, some may be able to reduce or shift their tax burdens to a former spouse by transferring deferred compensation in a divorce settlement, though the strategy is untested.

The Tax Cuts and Jobs Act eliminated the alimony deduction for couples who execute a divorce or separation agreement with alimony payments after Dec. 31, 2018. And while executive compensation, like restricted stock, options and other deferred pay, is typically not considered in the computation of alimony payments, it may come into play through use of Section 1041 of the Internal Revenue Code, which allows for no gain or loss to be recognized when property is transferred to a spouse or former spouse, but only if the transfer is incident to divorce, according to Brandon N. Mourges, a partner at Rosenberg Martin Greenberg LLP.

Some practitioners see a section of tax code that covers transfers of property to a spouse or former spouse as a way to reduce or shift tax burdens in the case of deferred compensation, though the strategy is untested. (AP)

"The new rules for alimony create additional incentives for tax planners to use Section 1041 as a tool, in lieu of deductible alimony," he told Law360. But "the desire to take advantage of IRC 1041 may run up against 'assignment of income' principles that may be employed" by the Internal Revenue Service.

"Generally, you are not allowed to voluntarily assign income to another person to reduce overall taxes, and the transfer of yet untaxed compensation could run counter to this," Mourges said.

Using Section 1041 may be attractive because when a higher-income spouse with a lot of unrealized gains transfers property to a former spouse, the lower-income spouse may benefit because he or she may be in a lower tax bracket, Mourges said. Section 1041 can also be used if the lower-income spouse has items with unrealized built-in losses that could be transferred to the former spouse in a higher tax bracket, he added.

"In arranging for these types of property settlements, the divorcing couple can increase the net after-tax value of property," Mourges said.

Taxpayers must comply with Section 1041, so if the equity rights are transferred incident to divorce, which means within one year of the end of the marriage where the transfer is related to the cessation of marriage, no recognition event will occur, he said.

However, more research is needed on whether the provision could be used if equity is not exercised until after one year, Mourges said. Another risk is that using the strategy during or after the one-year period may prompt the IRS to argue a divorce settlement involving remote or contingent property rights, like stocks and options, does not fall within Section 1041 or runs counter to the new alimony rules, he added.

Michelle F. Gallagher, a strategic partner and certified public accountant at Adamy Valuation Advisors Inc., said property splits have definitely been changing because of the elimination of the alimony deduction, but it is still too early to tell whether Section 1041 will be explored as a strategic option.

"I have not seen any trends of transferring options in lieu of alimony (yet) — probably because they are so complicated and speculative," she wrote in an email. "For the most part, we see the spouse who owns them will want to leave them as is and not mess with all the issues. However, if there is no liquidity in the marital estate or other assets to offset the option value(s), we sometimes see property settlement payments made later when options are exercised."

Gallagher said what she has seen so far is that when structuring a divorce that is a 50-50 split, more assets in the retirement area go to the person who would otherwise have seen an alimony payment.

Elizabeth Garrett, who is a partner, forensic accountant and attorney at Frazier & Deeter LLC, said Section 1041 provides for equitable division to happen as long as it is outlined in the settlement agreement and the same tax treatment is given.

"The shares that are already awarded and divided as marital assets are treated as assets under IRC Section 1041," she told Law360. "Any future awards that are considered for income and support purposes would not be divided as assets, but would be part of a support calculation."

When these equity awards will be a significant portion of the estate, they are typically divided on an "if, as and when" basis, which means when a stock or option vests or can be exercised, the nonemployee spouse receives the proceeds net of tax, Garrett said. Both members of the couple assume the risks, which are that the share price could change or that the employee-spouse could leave the company without receiving the unvested benefits, she explained.

Mourges told Law360 that having property settlements with stock options and deferred compensation can complicate reporting.

Practically speaking, if a working spouse has a stock right worth $1 million that will be exercised in five years and decides to split everything 50-50 with the nonworking spouse, the working spouse will get a W-2 that includes $1 million and has $300,000 to $400,000 of taxes withheld, but the nonworking spouse may receive, and possibly report, $500,000 in income and have only a small amount in tax withholding, he said.

This may mean the IRS does not know where the nonworking spouse's income is coming from and why the working spouse is reporting everything.

"Those planning to divide property that will produce strange information reporting to the IRS should be aware of this and probably build some language into their divorce agreement to address this," he said, such as "who should bear the cost in an audit to explain what happened."

While the denial of deductions for alimony raises interesting questions about the treatment of community property like stock options or deferred compensation, there is IRS guidance on the reporting requirements for executive compensation, according to Mary B. Hevener, a partner at Morgan, Lewis & Bockius LLP.

"The IRS issued guidance in 2002 providing that there is no income tax to the employee on transfer of the option to his or her former spouse pursuant to the divorce, but there is tax to the former spouse on the exercise or transfer of the option by the former spouse," Hevener said. Rev. Ruling 2004-60, which followed up on the guidance, requires Federal Insurance Contributions Act and federal income taxes to be withheld from the income that the former spouse receives, with the income tax withholding reflected as "backup withholding" on a Form 1099-MISC issued to the former spouse, and FICA taxes on a Form W-2 issued to the employee spouse.

What this means is that for the former spouse, most deferred compensation is taxable on transfers, she said.

"It would seem to me that a simple way to avoid losing an alimony deduction would be to work out a property division, including a division of deferred compensation accounts and equity compensation, with a smaller allocation to alimony," Hevener wrote to Law360. "But maybe that's just not possible — you'd have to talk to a divorce lawyer."

When she is working on a high-wealth divorce, Garrett said, she includes language in the settlement agreements explaining how the taxes will be calculated and reported on the employee spouse's tax return. For the most part, companies will not transfer stock options or registered shares to a nonemployee spouse, so the employee spouse is receiving all of the income reported on a W-2 or a 1099, even if the nonemployee spouse receives a portion or all of the equity grant, she said.

"There is typically a mechanism for withholding at the time of the exercise and a true-up at the time the actual tax return is filed," she said.

The mechanism that helps settle reporting and tax withholding issues is to create a constructive trust, where the benefits stay in the employee's name, and it's understood that they're subject to the terms of employment, Garrett said. So if the employee leaves or gets fired, he or she may lose all of the stocks or options, but if and when the equity grants are exercised the employee spouse acts as a fiduciary to the nonemployee spouse, Garrett said.

"So all of the income is still reported on the employee spouse's tax return, and in our agreements we

outline the specific calculation that's done to determine how taxes are deducted and how they're paid so the nonemployee spouse gets a net amount, which is the proceeds less the taxes," she said. "So it's still paid at the employees' rate, which will probably be higher, so really the IRS doesn't know what's happening with this money."

For example, if the employee spouse received $100,000 in equity grants, but the divorce agreement allocated $30,000 to the nonemployee spouse, the employee spouse would still report the full $100,000 and the nonemployee spouse would receive $30,000 minus the related taxes, Garrett said.

"I have seen two or three companies that have agreed to actually issue a 1099 to the recipient that is not an employee of their company because they have some sort of a clause that says in the event of a divorce, we will transfer it and we will do this, but I don't see this as a trend … and it is extremely rare," she said. "What I see for the foreseeable future is this will continue to be reported by the employee spouse."

--Editing by Robert Rudinger and John Oudens.