Valuing Unfunded Deferred Compensation Assets in Matrimonial Actions

Matthew C. McCabe*

I. Introduction

It is widely accepted that traditional pension plans are a marital asset, and much has been written about the proper method to use in determining the present value of defined benefit plan pension benefits in a matrimonial action.[1] Traditional pension plans are classified as "qualified" under the Employee Retirement Income Security Act (ERISA) and the Internal Revenue Code, allowing employers to deduct contributions from income and employees to build future retirement income on a tax deferred basis.[2] In return, qualified plans must meet rules regarding participation, vesting, contribution limits, and coverage of key employees versus employees generally. These plan assets are readily divisible in a matrimonial action through the application of a Qualified Domestic Relations Order (QDRO).[3]

In contrast, employers may also maintain seperate, nonqualified deferred compensation plans. A nonqualified deferred compensation agreement is a contract by which an employee or independent contractor agrees to be paid in the future.[4] The most common nonqualified deferred compensation plan is a "top hat plan." These are plans that are unfunded, and that are maintained by an employer for the primary purpose of providing a select group of management or highly compensated employees with deferred compensation.[5] Because unfunded deferred compensation plans are not qualified plans, they cannot be divided pursuant to a QDRO.

While unfunded deferred compensation plans are different from traditional pension plans in that there are no pools of funds available to provide promised benefits and because thay are not divisible pursuant to a QDRO, they are similar to traditional pensions in that the benefits promised are accrued as a result of an individual's employment. As a future benefit resulting from an individual's employment that is accrued during the course of a marriage, then, unfunded deferred compensation plan benefits are subject to equitable distribution in a number of jurisdictions.[6] For the economist who practices in a jurisdiction where unfunded deferred compensation plan benefits are considered to be a marital asset, the question becomes how these benefits should be valued.

* President, North Main Consulting

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1 See Ralph R. Frasca, "The Valuation of Defined Pension Benefits as a Marital Asset: An Abundance of Approaches," *Journal of Forensic Economics* 4(1), 1990, pp. 47-54.

2 Internal Revenue Code (26 USC) §§401, 404.

3 19 USC §1056(d)(3), 26 USC §§401(a)(13)(B), 414(p).

4 Mark P. Altieri, "Nonqualified Deferred Compensation Plans," *The CPA JournaI* 75(2), February, 2005, p. 54.

5 Campbell v. Computer Task Group Inc., August 1, 2001 N.Y.L.J. 25, Col. 5 (S.D.N.Y. 2001).

6 See, e.g., Douglas v. Douglas, 281 A.D.2d 709, 722 N.Y.S.2d 87 (3rd Dept. 2001),

II. When are Unfunded Deferred Compensation Benefits a Marital Asset?

There are few cases that provide guidance in determining when unfunded deferred compensation plan benefits are a marital asset. There are, however, a number of cases in several jurisdictions that address the valuation of a similar asset class in matrimonial actions. These cases adress the division of stock options granted in the course of employment during the term of a marriage.

Like unfunded deferred compensation plan benefits, stock options are granted in the course of employment. While stock option rights are granted in a particular year, they are often not exercisable for a number of years into the future. Similarly, unfunded deferred compensation plan benefits are granted in a particular year, but are not payable until either a specific date in the future or until the employee's retirement. Finally, stock option values generally increase over time with increasing stock prices, and amounts promised pursuant to an unfunded deferred compensation plan are often based upon a specific amount in the year in which they are granted, with interest accruing over the deferral period. Thus, there are many similarities between stock options and unfunded deferred compensation benefits.

The New York case of DeJesus v. Dejesus[7] provides a framework for determining whether stock options are marital assets. This same framework can be used in determining the marital portion of unfunded deferred compensation plan benefits. Using the procedure developed in the Colorado case of In re Marriage of Miller,[8] the DeJesus court specified the use of four seperate calculations to identify the marital component of a grant of stock options. The first step in this process is to identify which shares, or in the case of an unfunded deferred compensation plan, which benefits, have been granted for services rendered during the course of the marriage. These shares or benefits must be clearly identified as granted for past services, as compared with shares or benefits granted to ensure future services. Factors to be considered in determining whether shares or benefits were granted for past services include whether shares or benefits were offered as a bonus for past performance or as an alternative to a fixed salary, whether the value or amount of the shares or benefits will increase or decrease based upon future performance, and whether the shares or benefits were granted as a hiring incentive.

Once it has been determined that shares or benefits have been granted for past services, any shares or benefits that are intended to have been granted solely in return for past services are then deemed to be marital property to the extent that the grant occured during the course of the marriage. Any portion of shares or benefits intended to be an incentive for future services must be examined further to determine whether a portion of the incentive for future services is attributable to services performed during the course of the marriage. Past benefits granted as a result of services performed during the course of the marriage as well as future incentives based in part upon services performed during the course of the marriage can thus be classified as a marital asset, subject to equitable distribution. The question then becomes how to value this marital asset.

It should be noted that an issue that often arises in any discussion of whether unfunded deferred compensation plan benefits are a marital asset is that such benefits are often subject to forfeit if an individual leaves employment to work for a competitor. From an economist's perspective, it could be argued that for an individual to forfeit substantial future unfunded

[7] 90 N.Y.2d 643, 687 N.E.2d 1319, 665 N.Y.S.2d 36 (1997).
[8] 915 P.2d 1314.

deferred compensation plan benefits to work for a competitor, the competitor will have to offer the individual enough additional compensation to offset this potential loss of benefits. The argument could then be made that the ability to obtain such additional compensation was earned during the course of the marriage, and is thus a marital asset. The Appellate Division for New York State's Third Department endorsed a more simple line of reasoning in finding that unfunded deferred compensation plan benefits were a marital asset in spite of the potential for forfeiture. In the case of Douglas v. Douglas,[9] the employee's spouse's expert testified that "... no partner had left plaintiff's firm to work for a competitor in over 50 years..."[10] Thus, evaluating the probability of whether an individual will continue to work for a firm is necessary to establish the probability of whether an individual will receive unfunded deferred compensation plan benefits from that firm.

III. Valuing Unfunded Deferred Compensation Plan Benefits

Once it has been determined that unfunded deferred compensation plan benefits are subject to equitable distribution, the same considerations apply as in valuing qualified pension plan benefits. First, the economist must read the plan document to determine how funds are credited, whether and how much interest accrues on amounts contributed, and when withdrawals can be and must be made. After these variables have been established, the economist needs to determine how much will be available for withdrawal at specific future dates, including contributions plus accrued interest. Depending upon the law applicable to the particular jurisdiction, future amounts must be adjusted for potential income taxes payable. Finally, the future amounts must be discounted to present value.

Table A provides a sample valuation of unfunded deferred compensation plan benefits. The analysis shown in Table A was developed from an actual unfunded deferred compensation plan maintained by a major securities firm for the benefit of highly compensated brokers. In this example, the parties were married from 1995 through 2002. The employee deferred the stated amounts in each of the years shown. It should be noted that unfunded deferred compensation plan contributions can be elective, chosen by the employee, or paid by the employer in the form of deferred additional income with no election on the part of the employee, depending upon the terms of the plan. Especially in plans where there are elective deferrals, it is easy to see how amounts deferred into an unfunded plan should be classified as marital assets, representing compensation earned during the course of the marriage.

The deferred compensation plan shown in Table A credits interest on deferrals at the fixed rate of 5.0%, compounded annually. If a deferred compensation plan credits interest on elective deferrals, the actual interest rate may vary, and may need to be projected by the economist. For example, in the plan upon which Table A is based, interest on deferred compensation was credited for the first five years at the firm's cost of funds. Future interest was thus projected to be credited based upon an estimated "spread to treasuries."

The final consideration in evaluating the mechanics of an unfunded deferred compensation plan is the term from the date that contributions are made until withdrawals can be made. Because unfunded deferred compensation plans are not "qualified" plans, there is no

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[9] 281 A.D.2d 709, 722 N.Y.S.2d 87 (3rd Dept. 2001).
[10] 281 A.D.2d at 712, 713.

requirement that withdrawals be made by a specific age or only after retirement. In the example shown in Table A, lump sum withdrawals of contributions plus accrued interest can be made after 10 years. Of course, plans may specify a variety of withdrawal options. Plans may specify that payments must be made in annual or monthly installments, instead of lump sum amounts. There may also be a provision specifying that all amounts deferred on an individual's behalf are payable in a lump sum upon his or her death. It is incumbent upon the economist, then to know and understand plan provisions before building a model specifying how future payments will be made.

Table A: John Doe: Calculation of Annual Contributions and Credited Interest in the Acme Corporation Deferred Compensation Account

Year	Interest Rate	1995 Contribution	1995 Contribution Interest	1996 Contribution	1996 Contribution Interest	1997 Contribution	1997 Contribution Interest	1998 Contribution	1998 Contribution Interest	1999 Contribution	1999 Contribution Interest	2000 Contribution	2000 Contribution Interest	2001 Contribution	2001 Contribution Interest	2002 Contribution	2002 Contribution Interest
1995	5.00%	$5,000.00	$125.00														
1996	5.00%		$256.25	$7,500.00	$187.50												
1997	5.00%		$269.06		$384.38	$10,000.00	$250.00										
1998	5.00%		$282.52		$403.59		$512.50	$10,000.00	$250.00								
1999	5.00%		$148.32		$423.77		$538.13		$512.50	$10,000.00	$250.00						
2000	5.00%		$76.01		$222.48		$565.03		$538.13		$512.50	$10,000.00	$250.00				
2001	5.00%		$76.96		$114.02		$296.64		$565.03		$538.13		$512.50	$10,000.00	$250.00		
2002	5.00%		$77.93		$115.45		$152.03		$296.64		$565.03		$538.13		$512.50	$10,000.00	$250.00
2003	5.00%		$78.90		$116.89		$153.93		$152.03		$296.64		$565.03		$538.13		$512.50
2004	5.00%		$79.89		$118.35		$155.85		$153.93		$152.03		$296.64		$565.03		$538.13
2005	5.00%		$80.89		$119.83		$157.80		$155.85		$153.93		$152.03		$296.64		$565.03
2006	5.00%				$121.33		$159.77		$157.80		$155.85		$153.93		$152.03		$296.64
2007	5.00%						$161.77		$159.77		$157.80		$155.85		$153.93		$152.03
2008	5.00%								$161.77		$159.77		$157.80		$155.85		$153.93
2009	5.00%										$161.77		$159.77		$157.80		$155.85
2010	5.00%												$161.77		$159.77		$157.80
2011	5.00%														$161.77		$159.77
2012	5.00%																$161.77
2013	5.00%																

Table B details how payments will be made from the unfunded deferred compensation plan example shown in Table A. As shown in Table A, for purposes of this analysis, it was assumed that all amounts available for withdrawal would be withdrawn from the plan on January first of the year after the tenth year following the year during which contributions were made. The next consideration is the proper discount rate. By definition, benefits to be provided from an unfunded deferred compensation plan are not funded. That is, in order to avoid reporting and ERISA requirements, companies cannot set aside money to pay for unfunded deferred compensation plan benefits.[11] Because money is not set aside to pay benefits, and because these plans are not subject to ERISA, there is a degree of default risk. That is, because there are no seperate funds to pay benefits, deferred compensation plan benefits are contractual in nature, representing a claim against the firm's assets in general. If the firm goes out of business, the employee's promised deferred compensation plan benefits stand as an unsecured general obligation of the firm. There is some degree of risk, then, in participating in an unfunded deferred compensation plan.

Because of the default risk, the discount rate chosen to determine the present value of unfunded deferred compensation plan benefits must reflect not only the time period over which payments will be made, but also the firm's default risk. In order to quantify the firm's default risk, the appropriate discount rate can be obtained by chosing a rate similar to what would be used for business valuation purposes. While many different approaches are used to select the appropriate discount rate in business valuations,[12] the discount rate chosen in this example was developed as the average of the yields on Moody's seasoned Aaa and Baa corporate bonds as of the evaluation date, January 3, 2003. By definition, then, this evaluation assumes that the unfunded deferred compensation plan benefits were promised by a large, publicly traded firm with an investment grade credit rating.

Finally, in many jurisdictions, income taxes must be considered. In the example used, it was assumed that the taxpayer would have Adjusted Gross Income of between $200,000 and $500,000 per year, including unfunded deferred compensation payments, when benefits are received. Including both federal and New York State tax, the applicable tax rate is 30.15%. Reducing the annual benefits for the impact of income taxes thus substantially reduces the present value of the potential unfunded deferred compensation plan payments. Using this approach, then, as shown in these examples, the net present value of the marital portion of future unfunded deferred compensation plan payments is $42,725.11.

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[11] Mark P. Altieri, "Nonqualified Deferred Compensation Plans," *The CPA Journal*, Vol. 75, No. 2, Febuary 2005, p.1.

[12] <u>See</u> Thomas Ireland, Stephen Horner, James Rodgers, Patrick Gaughan, Robert Trout, and Michael Piette, *Expert Economic Testimony: Reference Guide for Judges and Attorneys*, Lawyers and Judges Publishing Co., Inc. (Tucson, AZ, 1998), pp. 139 - 140.

Table B: John Doe: Present Value and Net Present Value of Annual Deferred Compensation Payments

Date	Amount Available for Withdrawal	Present Value	Income Taxes Payable	Net Amount Available	Net Present Value
01/01/2003					
01/01/2004					
01/01/2005					
01/01/2006	$6,551.73	$5,378.33	($1,975.35)	$4,576.38	$3,756.76
01/01/2007	$9,827.59	$7,551.36	($2,963.02)	$6,864.57	$5,274.63
01/01/2008	$13,103.45	$9,424.33	($3,950.69)	$9,152.76	$6,582.89
01/01/2009	$13,103.45	$8,821.39	($3,950.69)	$9,152.76	$6,161.74
01/01/2010	$13,103.45	$8,257.02	($3,950.69)	$9,152.76	$5,767.53
01/01/2011	$13,103.45	$7,728.76	($3,950.69)	$9,152.76	$5,398.54
01/01/2012	$13,103.45	$7,234.29	($3,950.69)	$9,152.76	$5,053.15
01/01/2013	$13,103.45	$6,771.47	($3,950.69)	$9,152.76	$4,729.87
Totals:	$95,000.05	**$61,166.95**	($28,642.51)	$66,357.53	**$42,725.11**

Evaluation Date:	01/07/2003
Discount Rate:	6.835%
Average Income Tax Rate:	30.15%

The Discount Rate used was the average of seasoned Moody's Aaa and Baa Corporate Bond yields as of January 7, 2003, as obtained from the Internet Site maintained by the Board of Governors of the United States Federal Reserve (www.federalreserve.gov).

The average Income Tax rate consists of the average level of income taxes payable as a percentage of Adjusted Gross Income for 2001 for taxpayers with Adjusted Gross Income between $200,000 and $500,000 (23.30%) plus the maximum New York State income tax rate (6.85%). Income Tax information was obtained from the Internal Revenue Internet Site (www.irs.gov/pub/irs-soi/01in03at.xls) and from the Federal Tax Administrators Internet Site (www.taxadmin.org/fta/rate/ind_inc.html).

IV. Conclusion

In contrast to the well established procedures for valuing qualified pension plan benefits in matrimonial actions, little has been written regarding the evaluation of unfunded deferred compensation plan benefits. Because of the potential that promised unfunded deferred compensation plan benefits may never be received, many jurisdictions do not include such amounts as marital assets. For the jurisdictions that do count unfunded deferred compensation plan benefits as marital assets, the present value of these benefits can be a substantial component of the marital estate.