Divorce, Pensions and Retirement Benefits

Number: 35 Paul Commerford - President - LawDATA, Inc. October 2005

Defined Contribution Plans – Problems in Accurately Identifying the Marital Share

Introduction:

A defined contribution plan, unlike a defined benefit plan, does not promise a specific level of available benefits at retirement. In these plans, the employee or the employer (usually both) contribute to the employee's individual account under the plan, sometimes at a set rate, such as 5% annually of the employee's salary. These contributions generally are invested on the employee's behalf. The employee will ultimately receive the balance in their account. The ultimate account balance is based on the total contributions plus or minus investment gains or losses thereon. The value of the account will fluctuate due to the changes in the value of the investments. Examples of defined contribution plans include 401(k) plans, 403(b) plans, employee stock ownership plans, profit sharing plans, etc. It was once common practice to value the marital portion of defined contribution plans by using a simple coverture calculation (total months married while accruing benefits in the plan ÷ total number of months of plan participation on the marital property cut-off date = marital portion). With the dramatic swings in values in the equity markets (i.e., mutual funds) in which most defined contribution plans are invested this is no longer practical. But the problem is – based on available information – what is the best way to place a value on the marital share of the defined contribution account?

Practice Tip of the Month:

Before going ahead and having your client's, or your opposing counsel's client's retirement benefits valued, always compare notes with your opposing counsel to be sure you are in agreement on the basic data being submitted.

It is common for us to see two different requests for values from each of the spouses' attorneys. That's fine as long as the basic data is the same in each appraisal request. More often than not it isn't. The attorneys should agree on some objective data before incurring the cost of an appraisal. The following should not be controversial: dates of birth, date of marriage, date employment commenced, appraisal date (date for cut-off of marital property accruals), gross salary on appraisal date and plan termination date or actual retirement date, if applicable. The attorneys can dispute the appraisal date but they should first discuss it before having appraisals with two different dates. Any discrepancies in the foregoing information are going to require another appraisal. This can easily be avoided by comparing notes before submitting appraisal requests.

Defined Contribution Plans – Problems in Accurately Identifying the Marital Share

Today, defined contribution plans make up the bulk of the retirement schemes available to employees in the United States. Valuation of these plans present different problems than valuing traditional pension plans – defined benefit plans. In many cases it will be impossible to place an accurate figure on the marital share when the employee's participation commenced a number of years prior to the marriage. There are ways to deal with these situations but it is best that all parties are made aware of the difficulties that may be encountered.

DESCRIPTION OF SOME REPRESENTATIVE DEFINED CONTRIBUTION PLANS

401(K) Plan - The employee agrees to have a certain percentage of his gross pre-tax earnings withheld and paid to a company sponsored investment vehicle (usually a mutual fund company). The employer matches the contribution up to a preset percentage (i.e. 5%). The employee can usually put in more money than the percentage covered by the employer (i.e. 7% or 8%) and that also will be deposited with tax-deferred dollars. It must be a qualified plan. That means before the plan is allowed to start up the Internal Revenue Service must review and determine it meets the guidelines established by ERISA and IRS. There is a limitation to the amount of money that can be invested in a 401(K) plan. The employer can set the limitations but in no event can they exceed a figure that is set by the U.S. laws governing 401(k)'s.

ESOP – An Employee Stock Ownership Plan (ESOP) is a form of defined contribution plan in which the investments are primarily held in employer stock, often purchased at rates lower than the price that company stock is being sold for in the equity markets. This is usually a good incentive program for employees as their investments increase in value as the company increases in value through their efforts. If the company gets into serious financial difficulty then the employees' stock accounts will suffer the same fate as the company's stock suffers in the equity markets. It is possible to see the employee's whole account wiped out if the company fails (i.e., ENRON). But, if the employee starts with the company when it is very small, and continues as an employee through major growth and profitability, it is possible for an employee to become very wealthy based on his or her ESOP account alone (i.e., Microsoft).

Simplified Employee Pension Plan (SEP) – This is a relatively uncomplicated retirement savings vehicle. A SEP allows employers to make contributions on a tax-favored basis to individual retirement accounts (IRAs) owned by the employees. SEP's are subject to minimal reporting and disclosure requirements. Under a SEP, an employee must set up an IRA to accept the employer's contributions. Employers may no longer set up salary reduction SEP's. However, employers are permitted to establish SIMPLE IRA plans with salary reduction contributions. If an employer had a salary reduction SEP, the employer may continue to allow salary reduction contributions to the plan.

Profit Sharing Plan or Stock Bonus Plan – These plans are incentive plans as well as retirement savings vehicles. They are defined contribution plans under which the plan may provide, or the employer may determine, annually, how much will be contributed to the plan (out of profits or otherwise). The plan contains a formula for allocating to each participant a portion of the company's annual profit, usually based on the salary of the participant. A profit sharing plan or stock bonus plan can include a 401(k) plan as the vehicle for maintaining the distributions.

403(b) Plans – These types of Tax-Sheltered Annuity Retirement Plans are relatively unknown. That's because only certain employers are allowed to have them. If you are: employed at a public school or public university, a church, a public hospital or a charitable entity tax-exempt under section 501(c)(3) of the IRS Code you are allowed to have a 403(b) plan. Basically, 403(b) plans are similar to 401(k) plans that are maintained by "for-profit" entities. Just as with a 401(k) plan, a 403(b) plan lets employees defer some of their salary. In this case, their deferred money goes to a 403(b) plan sponsored by their employer benefit plans. They are required to accept Qualified Domestic Relations Orders and are subject to the same rollover rules that apply to other defined contribution plans.

457(b) Plans – A 457(b) plan is a deferred compensation plan that is generally only available to government and non-profit organization employees if their employing agency sponsors a plan. They usually are funded with fixed and variable annuities. It is a tax-deferred plan that offers a public employee an additional opportunity to save more money for retirement and save on taxes. This is a non-qualified plan and the plan administrators are not required to honor Qualified Domestic Relations Orders. Many plan sponsors (state or local government agencies) refuse to honor Qualified Domestic Relations Orders directed to them. If this asset is part of the marital estate you should always determine early in the action whether the plan accepts Qualified Domestic Relations Orders and negotiate the terms of the settlement agreement accordingly.

IDENTIFYING THE MARITAL PORTION OF A DEFINED CONTRIBUTION PLAN

By now, you should have a pretty good idea of what defined contribution plans are all about. They can most easily be equated to a tax-deferred savings account. While the concept is not hard to grasp, determining what portion of the account is marital property can be. Many employers now refuse to compute the passive growth on the non-participant spouse's share after the marital property cut-off date, so a pension expert will have to be called on to determine this value. Because the time frame between the marital property cut-off date and the projected distribution date is usually less than two years, identifying the values involved is, typically, not that difficult.

If the plan participant joined the plan after the date of the marriage it is relatively easy to assign a value to the marital property component (in many cases, defined contribution plan participation began many years after employment began because of the shift to defined contribution plans as the primary retirement benefit over the past 25 years). In that scenario each party to the divorce would be entitled to one half of the account balance on the marital property accrual cut-off date. The non-participant spouse would also be entitled to all interest, dividends, gains or losses that are attributable to his or her portion between the marital property cut-off date and the date the funds are actually distributed to them. Unless there are also other marital assets to offset the non-participant's share, defined contribution plan funds are usually distributed with a Qualified Domestic Relations Order.

This is a tax-free transfer to the participant and if a trustee-to-trustee transfer is made to another tax deferred retirement account (IRA, etc.). It is also tax free to the non-participant. Upon receipt and approval of a Qualified Domestic Relations Order, most plans will pay out the non-participant spouse's share immediately. If he or she elects to receive the money directly (no transfer to an IRA or other tax deferred retirement account) then the amount received must be added to his or her income in the year of receipt and all taxes incurred must be paid. The plan will automatically withhold 20% of the proceeds and pay it to the IRS in the name of the payee. In the case of direct payment to the non-participant spouse, the 10% early withdrawal penalty due on receipt of certain lump sum retirement accounts before age 59½ would be waived. This is an exception written into the federal tax laws specifically to facilitate marital breakup property distributions.

The difficulty in identifying the marital portion of a defined contribution account arises when the participant was already in the plan when he or she married. Most states treat the funds in the account on the date of marriage, plus all passive earnings on that portion of the account, as the separate property of the participant. There are two ways that the value of the separate property on the marital property cut-off date can be identified for distribution purposes - the easy way and the hard way.

The easiest way, and the way that, unfortunately, is no longer sanctioned by most courts, to apportion the account value at the time of the marital breakup is to a time value coverture calculation. If a participant began contributing to the plan on January 1, 1985, got married on January 1, 1990 and the marriage broke up on January 1, 2004, then the coverture calculation would be applied by simply dividing the fourteen years that the parties were married by the nineteen years the participant was in the plan and identifying the marital portion as 73.6842% of the account balance on the marital property cut-off date. The non-participant spouse would be entitled to one half of that or 36.8421% of the account on that date plus any post appraisal date earnings or losses on his or her portion. If the earnings and growth of the plan had been fairly consistent throughout the duration of plan participation this method would result in a distribution that should be deemed equitable by all parties. Unfortunately, in light of a very volatile investment market throughout the 1990's, and continuing through the present, that scenario rarely holds true.

Usually, the earnings, contributions and growth during the marital period have been erratic. The account must be analyzed in detail to determine the value of the participant's separate property with the goal of identifying the specific worth of that portion of the account on the marital property cut-off date and then bring that amount up to its actual value on a date close to the date the appraisal report is prepared.

This report will require the services of a third party consultant to analyze the growth, usually on a quarterly basis, throughout the marital period to ascertain the actual value of the non-marital portion of the account. The consultant's starting point is the value of the account on the date of the marriage. As many plans have options wherein the participant can allocate their funds to different investment vehicles, and optionally change them at will, this can be a very difficult and time-consuming exercise. Also, as mergers and acquisitions have not been uncommon during the past 25 years, just getting the necessary information from the employer can sometimes be impossible.

To perform the kind of analysis that will satisfy all concerned it is necessary to have all the quarterly investment reports provided to the participant during the marital period available for analysis. If you are talking about a fourteen-year marriage, unless the participant saved every quarterly statement, getting the necessary information will usually be impossible. Very few plans will provide this information if the participant has failed to retain his or her copies. This is a particular problem if the period in question is lengthy and the company has changed ownership or investment plan managers a couple of times. If some statements have been retained you can get close as long as two consecutive statements are not missing. But if two or more consecutive statements are missing, you force the analyst to move from science to art and the results can easily be challenged.

If the necessary information is unavailable, then the parties will either have to use the coverture method or come to agreement as far as a settlement figure. In the absence of evidence, it is doubtful that the cost of litigating the issue before a judge will produce a satisfactory result.

If the records are unavailable, one possible solution is to have an expert review the data that is available and come up with an opinion as to what a ballpark figure for the passive growth on the participant's separate property portion of the account might be. This will not be a figure that the appraiser would be willing to testify to as an expert witness. It is really just an informed opinion. That figure can be used as a starting point in negotiating an amount agreeable to all parties. If the attorneys educate their clients on the reality with which they are confronted, it is usually possible to come up with a negotiated settlement amount for the portion of the defined contribution account subject to distribution as marital property. In many cases this is the best that you are going to do in light of the absence of any other evidence.

orders promptly.

Model Property Settlement Language

Download our settlement language form and let the experts at LawDATA, Inc. draft model property settlement language (http://www.lawdatainc.com/SetLanForm.pdf) that deals specifically with the pension plan to which the order is addressed and the facts of your case.

Mr. Commerford has been active in the valuation of pensions and the preparation of Domestic Relations Orders for his attorney clients since the founding of LawDATA, Inc. in 1984. He has presented Continuing Legal Education programs, dealing with the valuation and distribution of retirement assets incident to divorce cases, for State Bar Associations throughout the country and written many articles on the subject for legal publications.

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