Divorce, Pensions and Retirement Benefits

Number: 30 Paul Commerford – President – LawDATA, Inc. May 2005

NEGOTIATING THE RETIREMENT BENEFITS SECTION OF THE SETTLEMENT AGREEMENT

Introduction:

The settlement agreement dictates the outcome of the property distribution process. While many assets can be easily identified and valued that is not always the case with retirement benefits. The biggest problem we see when requested to draft a QDRO for an attorney is the lack of specificity in the settlement agreement. Case law is now making it harder to correct the attorney's omissions by addressing them in the QDRO we draft. Both New York and New Jersey now have relatively recent case law that says if a provision is not clearly spelled out in the settlement agreement, it cannot suddenly appear in the QDRO. In New York the issue was survivor benefits in a public pension and in New Jersey it was post-retirement passive cost of living allowances (COLA). In both cases the failure to address these benefits in the settlement agreement meant the alternate payee would not receive an equitable share of the benefits earned during the marriage. In the New York case if the participant predeceased the alternate payee; the alternate payee would lose all benefits, In the New Jersey case the alternate payee's share of an obvious marital property benefit, would be paid to the participant. Both cases illustrate the importance of knowing the plan provisions and specifically addressing each provision in the settlement agreement. Many states have case law limiting QDRO provisions to only those that have been actually negotiated or awarded. If you are a faithful reader I am sure you have heard this message before but I keep coming back to it because when dealing with divorces and retirement benefits, this is where your potential problems will reveal themselves. Unfortunately many attorneys are still not getting the message.

Tip of the Month:

DON'T CONFUSE EMPLOYEE CONTRIBUTIONS REQUIRED BY A GOVERNMENT ENTITY WITH THE PRESENT VALUE OF THE PARTICIPANT'S PENSION.

Private, ERISA governed, pensions are usually 100% funded with employer funds. In public plans this is not the case. Public employees are usually required to contribute 5% to 9% of their gross income to their pension. These funds earn interest and if an employee quits or is terminated before they are eligible for retirement benefits they can withdraw them or roll them over into an IRA. The amount of these funds can be substantial. Many times the employee maintains that the gross value of these contributions, plus interest, is the present value of the pension benefits. Wrong. The funds to be contributed by the employing agency to pay for the pension benefit are never reflected in these contributions. A pension is valued by first projecting the monthly benefit amount, using the plan formula, that will be paid at retirement. Using that amount, you can then actuarially calculate the present cost of an annuity that will provide the same income at retirement. That figure will always be much higher than the employee contributions plus interest as it reflects the actual present value, including the plan provider's portion, of the pension.

NEGOTIATING THE RETIREMENT BENEFITS SECTION OF THE SETTLEMENT AGREEMENT

All retirement benefits that are <u>attributable to the marital period</u> are marital assets. This can include pension plans, annuities, 401k's, ESOP's and any other retirement savings scheme that enjoys favored tax treatment by the IRS. Retirement benefits are considered joint property and treated as any other marital asset. But before you can include them in your settlement it will be necessary to determine the present value of each retirement plan that is subject to distribution in the divorce. A pension consultant, actuary or an accountant, who has specialized knowledge in this area of his or her practice, can provide an appraisal.

The most important thing is for both parties to agree to the value of each asset. In most cases it is the lump sum present value of the future <u>pension plan component</u> that will present the most difficulty because these values are determined in an appraisal report by an expert using actuarial assumptions. There is no objective account balance. If each party had appraisals done, and there are differences, have the person who did your appraisal review the other spouse's valuation report to determine its accuracy and the appropriateness of the methodology used to value the pension. Based on this review you will have to decide whether you want to negotiate the difference or litigate.

If you litigate this means you will have to go to court and let the judge decide the value of the marital portion based on the reports and testimony of the individuals who prepared the appraisals. The expense of litigating with expert witness testimony can seriously impact the cost of the divorce and often the outcome is a gamble. Unless the difference between the two appraisals is substantial, and your expert can convince you that he or she can prevail in a fight over the values, negotiating the difference is usually the best way to go.

The goal is always to try to do an immediate offset settlement unless the non-participant spouse really wants a deferred settlement in order to have retirement income in the future or there are not enough marital assets to offset the value of the pension. An immediate offset settlement treats the values of each of the marital assets (including debt) as a tradable commodity and each party takes one component to offset a component being retained by the other. For example, the pension plan participant might offer the other spouse a larger interest in another asset (real estate, stocks and bonds, etc.) to enable the participant to retain full ownership of his or her pension. All of these trade-offs are documented in a Property Settlement Agreement signed by both parties at the conclusion of negotiations. An immediate offset settlement is only possible when the couple has accrued enough tangible assets to cover the values of intangible assets like the "good will" value of a business or the present value of a future, defined benefit pension plan retirement income.

The alternative to an immediate offset settlement is a deferred settlement. This can be in the form of future amortized payments, the receipt of a portion of the proceeds of the sale of real estate at some future targeted sale date (i.e., a child reaching a certain age or educational goal, etc.) or, if we are talking about retirement assets, future payments directly from the benefits provider. In order to defer the distribution of retirement assets, and have the provider pay the non-participant spouse directly, it is necessary to prepare a Qualified Domestic Relations Order (QDRO). This applies if the retirement plan in question is a private company with its employee benefits governed by ERISA, the federal law that controls employee benefits. The term "Qualified" means that it meets the IRS guidelines that govern how, to whom and when a private plan can distribute retirement funds other than on the early or normal retirement date of the plan participant.

If the retirement income is to be provided by a public plan (federal, state, local or military), you still need a domestic relations order but these plans are exempt from ERISA. Each has its own rules. All domestic relations orders require the plan to pay the non-participant spouse a portion of the pension or retirement account in the future. Most public plans require the former spouse be named beneficiary of the survivor benefit if it is intended that this be a property award and that the portion of the plan awarded to the spouse should survive the death of the participant. If this is not addressed the plan treats it as a support order and any payment awarded to the alternate payee ceases to exist if the participant dies prior to retirement or predeceases the alternate payee after retirement.

If it is a pension, then the non-participant spouse will receive his or her share in the form of monthly income when the participant is eligible to retire. If the retirement asset is some form of retirement savings plan (401k, ESOP, Profit Sharing Plan, etc.) then, in most cases, the portion of the account will be paid out immediately (on a tax deferred basis in certain circumstances) when the plan receives and approves the order. The use of Qualified Domestic Relations Orders when dealing with lump sum retirement accounts has become the norm because often these accounts are the only real source of cash the parties might need because of the divorce. The participant usually cannot take money out of the account without either quitting his or her job. If a portion of the fund is to be paid to a non-participant spouse as a property distribution with a QDRO, then, by increasing the amount to be paid out, they can also be used to retire joint marital debt (as long as the taxes that will be triggered are taken into consideration in the amount of the distribution being paid out).

Usually, the non-participant spouse's share of a pension is determined by a formula such as 50% of a fraction of the participant's monthly pension benefit at the time it goes into pay status. The fraction would be computed by dividing the total number of months married while employed by the total number of months of employment credited to the participant when the non-participant starts getting the monthly pension. There are other methods of identifying the non-participant's share depending on the state in which you practice.

A lump sum retirement savings plan (401k, ESOP, Profit Sharing Plan, etc.) is usually distributed using the account balance on the marital property cut-off date as the starting point. That date is set by state legislation or case law but, if agreeable, the parties can use any date they want. If the marriage spanned the total accumulation period of the account, then the non-participant spouse would usually get 50% of the account on the marital property cut-off date plus all interest, dividends, gains or losses credited to the portion of the account awarded to them until the money is paid out. If the participant was already in the plan at the time of the marriage then the non-participant would only get a percentage (usually 50%) of that portion of the account that accrued while married to the participant plus the post marital property cut-off date adjustments. If the non-participant spouse directs the plan, in a domestic relations order, to transfer his or her portion of the account to an IRA (trustee-to-trustee transfer) then no taxes are paid at the time of distribution.

There is little or no danger using a domestic relations order to distribute lump sum retirement savings type accounts other than the participant quitting his or her job, withdrawing all of the funds and fleeing before an order is entered. This risk can be avoided by notifying the plan of a pending domestic relations order as soon as the parties agree to the terms of the settlement. While not legally obligated to do so, Plan Administrators will usually hinder an attempted withdrawal to avoid involvement in a potential legal action. But if you are dealing with an interest in a future monthly pension benefit then you are about to enter a minefield.

The biggest danger is not knowing about, and dealing with, all the contingencies available in the plan. Attorneys practice law. They can't be expected to have the kind of specialized knowledge necessary to anticipate all the contingencies that might arise when dealing with the thousands of pension plans available. Because of this, few attorneys are able to prepare the specific property settlement agreement language needed to protect their clients in every situation. Many attorneys don't understand the importance of survivor benefits and their impact on the amount of pension that will actually be paid in the future. A non-participant spouse can receive as little as 50% of what he or she thought they had bargained for if the survivorship issue is not dealt with properly. Attorneys are not expected to, and usually don't, understand actuarial calculations.

The solution is to get help from a pension consultant before you enter negotiations so you are aware of all the benefits that the plan provides and know what plan provisions and contingencies should be addressed in negotiations. The best-case scenario is to have the consultant draft the portion of the settlement dealing with the retirement assets and bring that into the negotiations. That will insure that your starting position fully addresses your client's interests and a critical plan provision (i.e., early supplemented pension benefits, post-retirement passive pension income increases, etc.) is not overlooked. If you do not prevail on every issue, at least all of the plan's potential benefits and options will be on the table and what is finally agreed upon will be with the client's knowledge and acquiescence.

The attorney representing the non-participant spouse should always assume responsibility for at least the retirement benefit portion of the property settlement agreement language and the domestic relations order. He or she has the client who is receiving the benefit from the participant and is responsible for addressing all the plan contingencies. The participant's attorney has to be familiar enough with the pension plan to review and approve the language to insure it correctly addresses the terms agreed upon in the settlement negotiations.

Model Property Settlement Language

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.

For any questions or ideas for upcoming articles you can reach Paul Commerford at paul@lawdatainc.com.

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