



Divorce, Pensions and Retirement Benefits

Number: 17

Paul Commerford - President - LawDATA, Inc.

April 2004

RETIREMENT BENEFITS AND DIVORCE 101

Introduction:

I have been writing these monthly tip sheets for a little over a year so I thought it might be a good idea to sum up what we have learned thus far without going into the detail which is available in the previous articles. This month we will look at the whole process, with an emphasis on defensive practice. If some of these concepts are new to you, then I suggest you go back and read the previous articles available on this site. But for most of you this will be a refresher course on how to avoid problems when dealing with pensions and retirement accounts. As you must have discerned by now, much of what I have written is directed to the attorney representing the non-participant spouse. Attorneys who practice in the area of Family Law will find themselves in that role on a very regular basis. Even if the majority of the cases with which you are currently involved have you representing the participant, I can assure you that situation will not always be the case if your practice continues to include Family cases. It is in that role that you have the greatest exposure for potential malpractice problems. It is in that role that your understanding of the hazards involved is critical.

Tip of the Month:

Military Pensions – Uniformed Services Former Spouses Protection Act Orders (DRO'S)

As a general rule, Uniformed Services Former Spouses Protection Act Orders are distributed on a percentage basis using a formula. Pensions are immediately payable after 20 years of active duty but the order will not go into effect until the service member actually retires. Only the disposable retirement pay is available for distribution. Disposable retirement pay is defined as the gross retirement income exclusive of VA benefits. VA benefits are paid as compensation for any injuries incurred by the member while on active duty. In order for an order to be honored, the non-member must have been married to the serviceman for ten years that were concurrent with ten years of military service. However, the military will honor an order awarding "only survivor benefits" if the parties do not meet this rule. If the non-member and the member were married for at least 20 years, of which 20 years were concurrent with active military service, the non-member would also qualify for healthcare for life from a federally subsidized health services provider. Military reservist pensions are based on the points accrued (1 point = 1 day of active duty) and do not commence until age 60. A reserve DRO divides the portion of the pension based on the points accrued during the marriage.

A remarriage before the age of 55 by the non-member spouse negates any interest in survivor benefits from the military that may have been awarded in the DRO.

Retirement Benefits and Divorce 101

While much of the following will be familiar to you, it never hurts to review what has already been said. It is a particularly good idea to reacquaint ourselves with the potential hazards that are always inherent when you are dealing with retirement assets in divorce cases.

1. What retirement benefits are included in a divorce?

All retirement benefits that were accrued during the marital period are marital assets. This can include pension plans, annuities, 401k's, IRA's, ESOP's and any other retirement savings scheme that enjoys favored tax treatment by the IRS.

2. How are these marital assets treated in the divorce settlement?

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.

3. Once these assets have been valued what do I do?

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 pension plan component that will present the most problems because these values are determined in an appraisal report prepared by an expert using actuarial assumptions. There is no objective account balance. If you and your opposing counsel both had appraisals done, and there are meaningful differences in the values, have the appraiser who did your valuation review your opposing counsel's valuation report to determine its accuracy and the appropriateness of the methodology used. Based on this review you will have to decide whether you and your client want to negotiate the difference or litigate.

Always point out to your client that 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. Unless the difference between the two appraisals is substantial, and your expert says he or she can prevail in a fight over the values, try to get your client to accept the fact that negotiating the difference is usually the best way to go.

4. After the negotiated values are acceptable to both parties how should they be addressed in the property settlement agreement?

The goal should always be to try to make an immediate offset settlement unless the non-participant spouse really wants a deferred settlement in order to have retirement income in the future or the preferred distribution methodology in your state is to use a domestic relations order. 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 party a larger share of the marital property home by offering a credit of 100% of the value of the marital portion of the pension instead of a 50% credit, which is what the non-participant spouse would normally be entitled to get. The results of this transaction would increase the non-participant's interest in the home equity while the participant retains all of his or her pension. An immediate offset settlement is only possible when the couple has accrued enough tangible assets to cover the values of

intangible assets like future pension income or a defined contribution retirement savings account.

5. What if there is not enough non-retirement benefit assets to cover the value of the marital property retirement benefit assets being retained by the plan participant?

The alternative to an immediate offset settlement is a deferred settlement. Remember we are talking about retirement assets. In order to defer the distribution of retirement assets it is necessary to prepare a "Qualified" Domestic Relations Order (QDRO) if the retirement plan in question is a private company with its employee benefits governed by ERISA, the federal law that controls employee benefits. If the plan is a public plan (federal, state, local or military), you still need a Domestic Relations Order but these plans are exempt from ERISA and IRS rules and therefore do not require a "Qualified" order. 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.

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 free 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 participant cannot take money out of the account without either quitting his or her job, or if withdrawals are permitted by the plan, paying substantial tax penalties for early withdrawal in the absence of a Domestic Relations Order.

There is a way to make a deferred settlement without the use of a domestic relations order but it is only an option if the party with the higher value retirement benefits has substantial disposable income above what is needed to cover support issues and their own living expenses. If that is the case you can structure an amortized monthly payment over a period of years to bring the settlement deficiency into balance. This payment should include a reasonable interest rate in the amortization schedule. This may be an attractive alternative to the other spouse if they do not have marketable employment skills and are fearful about their immediate economic future. This method could provide additional income over a five to ten year period at a time when it will be really needed.

6. How is each party's share of the retirement benefit determined?

Usually, a pension share 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 determined 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 legislation and case law in 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 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 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 in his or her name (trustee-to-trustee transfer), then no taxes are paid on the distribution

7. What are the dangers in using Domestic Relations Orders for distribution of the retirement account?

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. Notifying the plan of a pending Domestic Relations Order as soon as the parties agree to the terms of the settlement agreement can reduce this risk. That notice does not bind plans but most will heed the warning and stall the participant to avoid potential litigation involvement. 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 do not, understand actuarial calculations.

Most pension plans have contingent provisions (i.e., supplemented early retirement benefits, cost of living adjustments, payment increases provided by post-retirement, renegotiated union contracts, etc.). Many public plans allow participants to make contribution withdrawals at the time of their retirement that will reduce their monthly lifetime pension. Many experts think private pension plans will disappear in the future.

The Property Settlement Agreement has to address all of the issues that are specific to the plan being addressed. There really isn't any boilerplate that covers all plans. Because of the potential problems, knowledgeable attorneys usually rely on pension consultants to prepare their Domestic Relations Orders. But if these contingencies, and many more like them, are not spelled out in the Property Settlement Agreement, they cannot suddenly appear in the Domestic Relations Order. Gone are the days when an attorney could put three vague sentences about the pension in the Settlement Agreement and the pension expert could craft an order that dealt with all the contingencies. Few opposing counsels would permit that today. All of the contingencies and plan options must be addressed in the Property Settlement Agreement. This can be the hazardous part of the settlement.

In New York State there is case law (Irato v. Irato, 288 A.D.2d 952, NY 2001) ruling that anything not included in a property settlement agreement cannot be awarded to the other party, after the fact, without the permission of both parties. The issue in contest was whether joint and survivor benefits could be included in a Domestic Relations Order if they were not awarded to the non-participant spouse in the property settlement agreement. The Appellate Court said absolutely no!

This is just one example of what can happen if you leave out a very important retirement option from an agreement. In the instant case the pension plan in question was a government plan that had no provisions for providing the alternate payee her share of the monthly pension if the ex-husband died unless she was named the beneficiary of the marital portion of the joint and survivor annuity. In a private company, ERISA governed plan, a non-participant spouse could get income (albeit, significantly actuarially reduced) for the

balance of his or her life whether or not the plan participant spouse predeceased them. Rather, in this case, without the wife being named as the beneficiary of the marital portion of the post-retirement survivor benefit, in the event of her ex-husband's death, before or after his retirement, she will lose all rights to any future pension income.

We anticipate any court reviewing this issue will come down with the same decision. In order to provide survivor benefits the participant's gross pension is usually reduced by about 10% to fund the necessary joint and survivor annuity. Both parties then share in the reduction on a pro-rata basis applied to the share of the monthly income awarded to them. If the parties had stayed married this would be the normal form of payment and the retirement protection they both anticipated. Because there is a cost involved to the plan participant, this makes survivor benefits a property component to be included in the property settlement agreement if they divorce. While there is no doubt that in a lengthy marriage survivor benefits should be the norm whether it is a private company or government agency plan, if it is not included in the property settlement agreement the non-participant spouse can suffer a substantial financial loss. Remember that, actuarially, females usually outlive males by many years. The absence of survivor benefits can mean poverty in the later retirement years for the non-participant spouse.

8. Who should be responsible for the Property Settlement Agreement language dealing with the pension and the preparation of the Domestic Relations Order?

The attorney representing the non-participant spouse should always assume responsibility for 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 be sure the non-participant is not over-stepping what should be an equitable distribution.

9. Is there anything I can do to protect myself in the negotiations if I anticipate a Domestic Relations Order will be used?

Pension consultants can draft model property settlement language that deals specifically with the pension plan to which the order is addressed and the facts of your case. Using experts for this part of your case can insure that all the contingencies in the pension plan are properly addressed in negotiations and in the Property Settlement Agreement as well as insuring that neither party is being short-changed. The cost of these services are usually inexpensive and well worth it to your client. In addition, the use of experts at this stage of the process will afford you additional protection to avoid potential future problems.

[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.

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