SECRETS OF NEGOTIATING
RETIREMENT PLAN DIVISIONS IN DIVORCE

Introduction:

Most people think of a divorce as an event. They do not understand that it takes time and effort to get an equitable outcome. It is the job of the parties' attorneys to educate them about the process and to help them obtain an equitable division of their assets. Asset division in divorce can be quite complex. Of course, sometimes people don't have anything other than a checking account and a car, but often, there are assets such as a house, rental property, business interests, investments and retirement plan accounts and benefits.

Judges are often not well-educated about the ins and outs of retirement plans, and many attorneys have no idea how they really work or the restrictions and regulations surrounding the division of this type of asset. The consequence is often an order which requires a type of division that the plan will not accept, or even worse, division of an asset that is not divisible at all. Why is that worse? If the total marital estate considered when dividing the assets between the parties included the alleged value of the non-divisible asset, the division is now skewed.

Another problem is an asset is divisible in a divorce, but the plan will not directly pay the benefit to the ex-spouse. If the court has ordered such a division, further litigation may be necessary to instead order the benefit participant to pay the asset directly to the other party. This type of division, called a "triangular" payment, and is made even more complex by the tax consequences involved. For example, if the ex-spouse is entitled to 50% of the marital portion of the asset, but the plan participant is receiving a net benefit due to the withholding of taxes and is paying taxes on the full distribution to him or her, it may be necessary to determine a net benefit for the ex-spouse to avoid the need for the participant to send a 1099R to the other party for each tax year.

Many attorneys hear "ERISA" and "IRS" and immediately shiver at the thought of having to figure out the application of these regulations to the assets being divided in a divorce. To avoid this, they often simply state in their settlement agreements that the parties will each receive 50% of the marital portion of each other's retirement plans, leaving the division and the many questions surrounding the division left to the next attorney who is retained to actually accomplish the division of these assets. Such lazy lawyering can lead to malpractice.

Education is key when negotiating a settlement for the client. In order to adequately represent the client, attorneys need to know more than just the statutes and case laws about division of assets. There are many other areas of law that intersect with family law – bankruptcy, investments, property values, business valuations, taxation and even criminal law often come into play when looking at the issues in a divorce. Knowing how to value, what to divide and how to do it equitably can help attorneys avoid possible malpractice issues.

I. WHERE TO START - DISCOVERY

"Discovery" – that dreaded word for many. Often, when a divorce case doesn't seem very complex, attorneys exchange only the minimum of documents – a Financial Affidavit and the most recent asset statements. Then they start negotiating the settlement. Unfortunately, if there are assets such as a house, business interests or retirement plan accounts or benefits, there is probably more information needed before adequately negotiating the client's settlement.

A. *Documents to Determine the Value*: Often even pension plan statements show a "balance." However, the "value" is not necessarily the balance that is listed. "Value" depends on the type of benefit. In order to determine that, an attorney needs to know about the plan.

   i. Employer Sponsored Plans. Each employer sponsored plan has a plan document with details of the plan. The summarized version is called the Summary Plan Description. Obtaining a copy of this document, along with the last 2 – 3 years of account/benefit statements will provide a good picture of the benefits. In addition, knowing the participant's participation commencement date is important for determining marital and non-marital portions.

   ii. Individual Retirement Plans ("IRAs"). For IRAs, in addition to obtaining a copy of the last 2 – 3 years of account statements will provide a good picture of the account. Of course, knowing when the person started the account and if any monies were transferred to establish it is important for determining marital and non-marital portions.

   iii. Government Plans/Benefits. CSRS, FERS, Railroad Retirement, military pensions – these all have different and often very restrictive benefits available for division. Many have deadlines for submission of documents to divide the benefits. These often have very detailed attorney guides which can educate the attorney so that the client obtains an equitable division of these assets, if the asset is divisible.

B. *Documents that Show Employment Status Information*: It is important to know if a person is an active participant or if he/she has terminated participation in the plan. Also, if the participant is receiving pension benefits, it is important to determine what benefits are able to be divided and how to do that. If the participant spouse does not cooperate in providing that information through routine discovery requests, it may be necessary to send a subpoena to the pension plan to obtain that information, along with the above information which can also be obtained from the plan.

C. *Plan Documents Showing the Specific Divisible Benefits*: Before drafting any settlement agreement, the attorney must know what aspects of a pension or other retirement plan can be divided and how to divide it. Does the pension allow for death benefits to be divided? If so, which ones – just pre-retirement death benefit or all death benefits? Does the plan

have "cost of living adjustments" (COLA)? Will the plan allow the ex-spouse to have a portion of any early retirement subsidies? Is the benefit available as a lump sum or only a monthly benefit? When is the benefit available?

D. *Model Qualified Domestic Relations Orders or Forms to Transfer Monies*: For employer sponsored plans, reviewing a copy of the plan's model Qualified Domestic Relations Order ("QDRO") will assist in knowing how that benefit can and cannot be divided when read in conjunction with the Summary Plan Description document. For IRAs, getting a set of procedures for division of the account and any forms necessary for same will assist in drafting the language for the settlement agreement.

II. KNOWING WHAT IS BEING OR CAN BE DIVIDED

By reviewing the discovery, an attorney should be able to determine what benefits are available to divide, if any, if a plan will pay an ex-spouse directly and what type of plan it is – a defined benefit plan, defined contribution plan or some other type which requires special consideration when attempting to divide the asset.

A. *Determine the Type of Plan*: There are several types of plans and when negotiating a settlement for a client, an attorney must understand what type of plan is being divided.

i. Defined Contribution Plans. This the type of plan includes plans such as 401(k) plans, profit sharing plans, stock purchase or option plans, most of which are regulated by statute. "401(a), 401(k), 403(b), 457" are all Internal Revenue Code ("IRC") sections – specifically Employee Retirement Income Securities Act ("ERISA") sections which govern employer sponsored plans which are regulated by these statutes. These plans include employee contributions and often also employer matching contributions. The benefits are typically (but not always) These are often divisible by giving the ex-spouse a specific percentage or dollar amount from the participant's plan account. However, this is not always the case. Stock option plans, for example, often have unrealized benefits – the option to purchase stocks, which option occurred during the marriage, but the exercise of which will not be available until after the date of divorce. It is important to know what, how and when the benefits can be divided. Reading the plan's Summary Plan Description can give the attorney that information. Also, often the plan administrator for a defined contribution plan will not accept language which asks them to determine the "marital portion," the benefit that accrued only during the parties' marriage by using a formula, such as Illinois' *Hunt* formula, created by the Illinois Appellate Court in the Illinois case, *In re the Marriage of Hunt* (78 Ill.App.3d 653 (1979)). These benefits are more like a savings plan with a balance at any given time, not a formulated accruing benefit. Therefore, it is difficult to ask the plan to determine a "marital portion" as if it *was* a formulated benefit.

ii. Defined Benefit Plans. These are usually only available as a monthly benefit and usually only available at the participant's retirement age. It is important to know if the plan allows for a lump sum distribution, and if it does, when that distribution is available. It is doing the client a disservice if the language of the marital settlement agreement provides for an impossible division such as giving an ex-spouse a lump sum benefit that does not exist in the plan provisions or $20,000 from pension benefits when the plans provide for life time payments. This only creates future litigation and/or court involvement. It is also a disservice to assume that this benefit is valued by looking at the "contribution balance" or other "value" listed on a benefit statement, and that therefore, this benefit has a value that is able to be offset against other assets. In other words, the value is really the monthly benefit multiplied by the number of months the benefit will at some point in the future be received by the ex-spouse. For example, if the ex-spouse is to receive $500 per month and she lives long enough to receive it for 20 years, or 240 months, the real benefit would be $120,000.00. However, when trying to offset this benefit, a present value has to be determined. Often an attorney is not equipped to determine that value. It is often best to retain the services of an actuary or retirement plan consultant who can calculate an estimated present value of the monthly benefit. Once the "present value" of the benefit is determined, the attorney can determine if it is possible to offset that benefit.

iii. "Non-Qualified" Plans. Not all plans are "qualified", meaning regulated under ERISA. Companies are permitted to have plans for certain groups, such as executives who want to contribute more than permitted under ERISA each year. These plans, often called "top hat" plans, also have plan documents which list their provisions. However, these are often much more restrictive in the ability to divide these between spouses with the plan paying the benefit directly to the ex-spouse. Many times, the plan will not pay anything directly to the ex-spouse. An attorney needs to know how these can be divided or offset by other assets before negotiating the settlement.

iv. Government Plans/Benefits. This area of asset division has may opportunities for committing malpractice when an attorney is not properly familiar with these tricky plans. Many state pensions and retirement plans are not divisible by direct payment from the plan. For example, Mississippi "PERS" plans cannot be divided by court order asking the plans to pay the ex-spouse his/her portion of a state employee's benefits. Many federal plans have very restrictive provisions about when an ex-spouse is eligible to receive any benefit from the plan, and often have deadlines for submission of documents to secure that benefit. Military plans are especially tricky. Railroad Retirement pensions are divided into tiers, one of which has provisions mirroring Social Security benefits, and the other, Tier II, being assignable by court order to an ex-spouse if the order contains the proper language. Most government and military plans have documents which are guides for attorneys when these plans are involved in a divorce. Educating oneself about these benefits and plans is important when attempting to negotiate an equitable settlement between divorcing spouses.

B. *Benefits Not Payable Directly*: If the plan will not pay any benefit directly to the ex-spouse, the attorney needs to know how to craft the language of the settlement agreement to meet the needs of the client, by either providing for "triangular" payment directly from the participant to the client with the taxation issue addressed since the participant will be the one taxed upon receipt by the participant of the full amount; or offsetting the benefit – if it is equitable to do so. Knowing when to offset is important as the attorney can inadvertently cause the payment of higher taxes by the client if the tax consequences are not considered.

C. *Tax Considerations*: Determining the type of retirement plan will help determine the tax consequences of dividing the asset. It is vital when negotiating to know how an asset will be taxed upon division. For retirement plans, will there be income tax plus a 10% early withdrawal penalty if the ex-spouse is not 59 ½ or older? Reviewing the Summary Plan Description can assist to make that determination. For pensions, will it be paid directly to the ex-spouse and taxable to them? If a "triangular" payment is necessary, then how is the tax issue dealt with since the plan participant with that somehow deducted from the amount awarded to the ex-spouse?

   i. Payments under ERISA. Normally, if a person takes a withdrawal or distribution from his/her IRS regulated retirement plan, the distribution will not only be subject to income tax, the distributee will also pay a 10% early withdrawal penalty. Attorneys often do not understand the taxation issues when dividing assets, resulting in potential malpractice issues. For example, if the ex-spouse takes a distribution from her spouse's employer sponsored retirement plan – such as a 401(k) plan – the ex-spouse will pay income tax on the distribution but will not pay a 10% penalty if the lump sum is taken directly from the account set up for the ex-spouse upon entry of a QDRO.

   ii. Payments under Non-Qualified Plans. If the ex-spouse is awarded the other person's IRA account or part of the other party's non-qualified retirement plan such as a "top hat" plan, this can be taxed differently than if the distribution comes from an ERISA regulated plan. For example, if the ex-spouse receives monies from an IRA, there is no exception to the 10% penalty if the person is under age 59 ½, and any distribution paid to her will be subject to income tax and the 10% early withdrawal penalty. Top hat plans that allow payment to the ex-spouse are often taxed as regular income with a Form W-2 provided instead of a Form 1099R.

   iii. Government Plans. Payment in these plans can be dependent upon the type of benefit chosen by the participant, or can be taxed like regular income, or can be determined by other government regulations such as Social Security benefit rules. The taxation is often affected by this and an attorney should educate himself about these plans before attempting to divide or offset these plans or benefits.

III. KNOWING WHAT TO FIGHT ABOUT

A. *Determining the "Marital Portion"*. In many states, statutes or the courts, provide for provisions about division of retirement plan benefits even when a portion of the balance or benefit accrued or accumulated prior to the parties' marriage or the participant continued to accrue a benefit after the parties' divorce. Addressing this issue for defined benefit plans is often easier than for defined contribution plans.

i. Defined Contribution Plan. If the balance in a defined contribution plan was all accumulated during the marriage, there is no need for worry – just divide the asset and remember what elements to include in the division. However, if the participant was in the plan prior to the parties' marriage, how do you determine the "marital portion"? There are several ways to determine the marital portion for a defined contribution plan, and an attorney needs to determine the best of these before negotiating the settlement or determining the percentage or dollar amount to be awarded to the ex-spouse of a participant.

a. *All Statements Available*. If the participant or attorney has the ability to obtain all of the plan statements from the date of marriage though the date of divorce, these can be sent to an actuary who can provide a fairly accurate figure for the marital portion. No fight needed.

b. *All Statements Not Available*. This is where the litigation occurs. There are several ways to estimate the marital portion.

(i) One method is for the attorney to simply take the balance as of the date of dissolution minus the balance as of the date of marriage. This is certainly one method. However, this method does not account for any earnings on the balance that accrued before the marriage, so the marital portion will probably be higher than with different formulas.

(ii) Another method is to use the *Hunt* formula or the formula in the attorney's state which is used to determine marital portions in defined benefit plans. This is a little more accurate than using the first balance minus balance method. However, this assumes earnings and contributions that are the same throughout the life of the account, which is not how the typical account works, of course.

(iii) There are other methods which have been used and are sometimes codified in a given state. An attorney should familiarize himself with the statutes and cases surrounding the area of determination of marital portions.

B. *Does a Formula Always Matter*? Attorneys often argue about how to determine the marital portion. In Illinois, the court uses what is referred to as the *Hunt* formula established by *In re the Marriage of Hunt* (78 Ill.App.3d 653 (1979)). Before negotiating

a division of a plan, the attorney should determine if there is a non-marital portion to the benefit or balance being divided, and if so, how to determine the marital portion to be divided.

i. Often a plan's model QDRO will use language that simply provides for the ex-spouse (the "alternate payee") to receive 50% of the benefit that accrued between the date of marriage and the date of divorce. If the plan makes the determination as to what that means, it may lead to a lower benefit for the ex-spouse. Remember that plans are for participants, and often, the language a plan chooses will be participant friendly. If salary is part of the pension formula and the plan uses the salary as of the date of divorce rather than as of the date of retirement, it can make a difference in the ex-spouse's monthly benefit.

IV. DRAFTING THE LANGUAGE

A. *Language is crucial*. It is important to negotiate all of the benefits and aspects of each benefit for every benefit being divided. If the settlement document does not list certain benefits and there is a dispute between the parties as to whether that benefit should be awarded, the court will often not allow division of that benefit because it isn't specifically provided for in the settlement document. In addition, it is imperative to list how the benefit division will be accomplished, and if the attorney or firm handling the matter does not do this type of work, this should be clearly stated, maybe even listing who is to do the work so the client knows where to go for that to be done. It is always best to at least seek the counsel of an expert in the area of retirement plan divisions prior to moving forward with drafting a QDRO, QILDRO or other order to divide retirement plan benefits. There are complexities in drafting a QDRO that must be considered to avoid malpractice in that area as well. The clearer the settlement document is about what is being divided, and how it is to be accomplished, the better off your client will be when it is time to actually divide the benefit. Avoiding litigation should be one of the main focuses for attorneys when drafting the settlement agreement for division of retirement plan benefits. The type of benefit once again determines much of the language that should be used.

i. Defined Contribution Plans. For defined contributions plans, make sure to include the following in the settlement agreement when stating the awarded asset:

a. *Which Plan*? It is important to state the name of the plan, or at least the name of the employer and type of plan, being divided. Often attorneys will use language such as "the wife shall receive 50% of the marital portion of the husband's Vanguard 401(k) plan." This is vague language in several ways. First, as stated earlier, the specific percentage or dollar amount should be listed, not simply "50% of the marital portion" as this leaves determination of the "marital portion" undetermined, leading to more costs later for another attorney to determine how to determine that phrase and the portion actually being divided. Second, stating the plan sponsor rather than the employer or name of the plan leads to the

necessity of further discovery when the asset is actually divided. Vanguard is a plan sponsor for numerous plans and it later becomes necessary to determine the plan, either by discovery to the participant or by sending a subpoena, both of which can result in delays in division or litigation that could have been avoided simply by stating that "the wife shall receive 45% of the vested balance in the husband's Citgo 401(k) plan as of the date of the parties' dissolution of marriage, which 45% constitutes 50% of the marital portion of said benefit."

b. *Earnings or No Earnings*. People often assume that their awarded amount will include the earnings (market gains and/or losses), but if the settlement agreement does not state that earnings are included, if the issue is disputed, many times the judge will not award the earnings to the ex-spouse as that benefit was not specifically stated in the parties' settlement contract. The issue of whether to include or exclude earnings should be determined before drafting the agreement. To know whether to include earnings, the attorney needs to understand the situation of the client and the parties. For example, if the client needs to know that he is getting a certain amount from the other party's 401(k) plan so that he can plan his purchase of a home, then he may not want earnings included because "earnings" include gains *and* losses, so if there is a potential that the account will lose money, resulting in receipt of an amount less than needed for the home purchase, the attorney would want to exclude earnings in the division of the 401(k) plan.

c. *Outstanding Loans*. Often attorneys do not even notice – or inquire – about any loans taken from a 401(k) or other ERISA regulated defined contribution retirement plan. The balance listed on a participant's account sometimes includes the balance of any outstanding loan, meaning, it lists the balance which would be in the plan if there was no loan outstanding. Then the statement breaks down what is included, listing the gross balance, the outstanding loan and the net balance. However, often, loan information is not found on the summary of the balance and it is unclear, then, if the loan balance is within the balance listed or if it should be added in to determine the gross benefit. It is important to understand the true balances so that the total amount of assets can be properly divided. It is also important to understand the purpose of any outstanding loan. Was it used to pay off both parties' credit cards? Was it used to update or payoff an asset that is only being awarded to the participant? If it was for a personal purpose such as that or such as being used for the participant's own debt or attorney's fees, the amount awarded to the other spouse should not be decreased since it wasn't used for them or for the marital estate. If the participant used the loan to upgrade the parties' home, which is then being sold with the proceeds divided upon sale, that was a use that should be borne by both parties. To draft the language so that the participant is the only one bearing the burden for the loan, the attorney must state that "any outstanding loans should be included when determining the balance awarded to the other spouse." If the burden of the loan is to be shared by the

parties, then the balance of any outstanding loans is "excluded" when making that determination.

ii. Defined Benefit Plans. If the plan being divided provides for monthly payments, the attorney needs to be familiar with the benefits available for division under the specific plan(s) in the case. Make sure that the list is comprehensive and has language such as "including but not limited to" so that the ex-spouse does not lose a benefit to which she may have otherwise been entitled. These plans often allow for an award of not only the monthly pension benefit, but also pre-retirement survivor spouse benefits, early retirement subsidies, cost of living adjustments, and any additional lump sums which may be a part of the plan benefits.

iii. Government Plans. If the attorney has properly familiarized herself with the provisions of these plans which are relevant to the division of assets in the client's case, she should list any deadlines, special documentation and/or orders needed to accomplish division of the asset, as well as the types of benefits to which the ex-spouse will be entitled. It is often best to consult with an expert in the area of retirement plan divisions prior to attempting to negotiate or draft language for the division of these more complex retirement plans.

iv. Stock Options, Non-Qualified Plans and Other Complex Plans. One type of plan that can be confusing and difficult to divide is stock options through employment. The complexities arise due to the granting of an "option" during the marriage but which may not be available to be exercised until long after the date of divorce. Many times, these are exercisable in stages. Understanding the provisions of these plans, much less knowing how to draft language for division, can be daunting. There are other unusual plans and an attorney must be familiar with the provisions of all plans which he wants to divide in a case prior to negotiating and drafting the language for division of a complex plan benefit. Of course, if a plan is not divisible by direct payment to the ex-spouse, the attorney must understand the complexities involved in drafting the language to account for the issue of taxation.

V. EDUCATING THE CLIENT

What next? Often, the divorce is finalized and no orders have been entered to accomplish the division of the retirement plans. Sometimes that is necessary since the date of dissolution is often the valuation date and the value for that date won't be known until afterwards. If there is still work to be done to accomplish division of retirement plan benefits, or any assets or debts, for that matter, don't leave the client hanging. It is a recipe for disaster and malpractice. Often the client believes the settlement document is sufficient to divide retirement plan benefits, or assumes the attorney handling the divorce will automatically proceed with handling division of those assets. The attorney must tell the client what needs to happen next – and putting it in writing is the best policy. If the client will need to contact someone else to help with the division, providing the client with the contact information for

that person in that correspondence is a good practice. Clients are often exhausted by the end of the case and overwhelmed with everything happening. It is a good practice to send a follow up letter or email reminding them of what they need to do after their divorce. Not communicating these important steps to the client can lead to angry former clients, and worst of all, malpractice claims.

VI. KNOW WHENT TO RETAIN THE SERVICES OF AN EXPERT

Often attorneys in family law must know about other areas of law. The attorney needs to know when to consult with someone who can help the attorney understand the area of retirement plan division or to draft language for the settlement agreement or QDROs or other orders to accomplish the division of assets. As attorneys, we are to be competent in the area of law we practice, and if the attorney needs education or information, she should seek the services of someone well-versed in that practice area. An expert can be a consultant, a drafter or expert witness. He or she can assist in determining the marital portion and the divisions available for the retirement plans of the divorcing parties. Some experts can even review all of the assets of the parties to give advice to the attorney or to the client directly as to the best division based on the client's situation. If given sufficient information, an actuary can do a valuation of the non-marital and marital portions of the benefits to assist in valuing things for division. An attorney should never hesitate to ask for help. It is the mark of a good attorney.

VII. CONCLUSION

So if you are an attorney trying to help someone determine the best options regarding retirement plan divisions, or if you are a party in a divorce and need to have the orders entered to divide the retirement plans, it is best to seek the help of an attorney who knows the ins and outs of retirement plan divisions in divorce. At Petersen Law and QDROs LLC, we are ready to give you assistance with whatever you need!