Retirement Benefits in MSAs | *Elizabeth Sales, J.D., L.L.M. in Taxation* | *March 26, 2009*

HOW TO CHOOSE APPROPRIATE MSA LANGUAGE WHEN A QDRO IS REQUIRED

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Three categories of retirement benefit plans that require a QDRO or DRO:

1. Defined Contribution Plans
   Plans which have a current account balance because the benefits accrue based on the contributions made by the employer and the employee.
   Examples: 401(k), ESOPs, Profit Sharing Plans

2. Defined Benefit Plans
   Plans which do not have a current balance and instead provide a fixed benefit at retirement which can be paid in a lump sum, monthly payments, etc.
   Example: Private Pension Plan

3. Government Plans
   Examples: CSRS, FERS, TSP, CalPERS, CalSTRS, Military, SDCERA, SDCERS

What is a QDRO?

QDRO: Qualified Domestic Relations Order

Prior to the Retirement Equity Act of 1984 (“REA”) an inherent conflict existed between the Internal Revenue Code (“IRC”) Section 401(a)(13) and state domestic court proceedings which ordered payment of plan benefits to a spouse or other dependent in a dissolution

REA adopts the concept of a “qualified domestic relations order” so that no order of any state court will effect a transfer of qualified plan benefits to the spouse, child, or former spouse of a plan Participant unless is it a QDRO

What does a QDRO accomplish?

- Assigns retirement benefits to the former spouse (alternate payee) upon dissolution
- Avoids the 10% early distribution penalty pursuant to IRC 72(t)(2)(c) and the 2.5% California early distribution penalty
- QDRO is required for assignment of benefits in all "qualified" plans

What is a “qualified” plan?

Qualified means that the ERISA plan is qualified under certain provisions of the Internal Revenue Code

If the plan complies with the certain provisions of the Internal Revenue Code, then it will be qualified to have favorable tax status (i.e., contributions made to qualified plans are tax deductible and earnings in most tax qualified plans are not taxable until distribution)

Most defined benefit and defined contribution plans are qualified

Red Flag: Look for the words “non-qualified” to signal when a plan is not qualified, i.e., a Non-Qualified Deferred Compensation Plan

What is a DRO?

DRO: Domestic Relations Order

Assigns non-qualified plan benefits to former spouse (i.e. government plans)

DRO is required for Government Retirement Plans because these plans are highly regulated and the government can require that participants and alternate payees follow certain procedures in order to divide the benefits

Most IRAs do not need a DRO, but check with the IRA administrator to determine whether a particular IRA needs a DRO to divide retirement benefits

How do you divide retirements plans that are not “qualified” and are not governmental?

Examples: IRAs, Stock Option Plans, Non-Qualified Deferred Compensation Plan, any other Non-Qualified Plan

Answer: Ask the plan administrator if the plan will accept a DRO

- If yes, use DRO to assign the benefits. (Do not forget about taxes.)
- If no, use a private out of court division agreement to divide the benefits or negotiate the buy-out the plan (keeping in mind the high risk of error in a buy-out)

Drafting Your MSA

If possible, enter a QDRO or DRO at the same time as dissolution can avoid many problems for your client.

<u>Potential Problems</u>:

1. Value of assets in plan have decreased or increased significantly since MSA
2. Loan balance in plan may exceed value of assets or plan administrator may be unwilling to transfer assets to alternate payee due to high loan balance
3. Plan administrator may not allow for division in the way previously anticipated (i.e. no survivor's benefits or cannot begin benefits until participant actually elects, necessity of Gilmore election, etc.)

Conclusion:
Do your QDRO early and get it pre-approved by the plan administrator (and a benefit estimate if possible) before signing the MSA and QDRO

Alternative:
Contact a QDRO Attorney early to ask about the available QDRO provisions for a particular plan before the MSA is signed and any issues that will have to be determined

Drafting Your MSA: California Family Code § 2337

Each party (insert names and addresses) is provisionally awarded without prejudice and subject to adjustment by a subsequent domestic relations order, a separate interest equal to one-half of all benefits accrued or to be accrued under the plan (name each plan individually) as a result of employment of the other party during the marriage (or domestic partnership) and prior to the date of separation. In addition, pending further notice, the plan shall, as allowed by law, or in the case of a governmental plan, as allowed by the terms of the plan, continue to treat the parties as married or domestic partners for purposes of any survivor rights or benefits available under the plan to the extent necessary to provide for payment of an amount equal to that separate interest or for all of the survivor benefit if, at the time of the death of the participant, there is no other eligible recipient of the survivor benefit.

Drafting Your MSA: Defined Contribution Plans

The parties agree to jointly retain _________ to draft the appropriate Qualified Domestic Relations Orders to divide equally the community property accumulated in the (names of plans) where the community property interest is defined as the sum of all contributions due to employment during marriage and adjusted for any earnings and losses until the final date of distribution to the non-participant spouse.

Function of a QDRO for Defined Contribution Plans

- Instructs the plan administrator to add the contributions made by the employee and the employer due to employment from the date of marriage to the date of separation adjust for earnings and losses and award one-half to alternate payee.
- Contributions made by employer after separation for efforts during marriage are also community property.

Example of Calculation by Plan Administrator

DOM: 1/1/05 DOS 1/1/07

Contributions:

2/1/05	$2,000 (made by employee)
2/1/06	$2,000 (made by employer for 2005 year)
2/1/07	$3,000 (made by employer for 2006 year)

Assume zero earnings during 2005, 2006, and 2007

Community Property equals: $7,000

If QDRO is not entered until 1/1/09, $7,000 will be adjusted for earnings and losses in the plan investments during 2008 (approximate loss of 30%)

Alternate Payee is awarded: 50% of $7,000 reduced by 30% equals $2,450

Distribution Options Available to Alternate Payee

An alternate payee has two distribution options:

1. Take distribution in cash into checking account

   $2,450 reduced by federal tax 28% and California state tax 9.3% equals $1,536.15

   No federal or state penalty

2. Roll over benefits to an IRA (have 60 days from receipt of payment)

   $2,450 is rolled over and $913.85 is deferred in taxes

Pitfalls in Drafting Your MSA for Defined Contribution Plans

- Using a specific dollar amount: Solution, insert an effective date and provide for adjustment of earnings or losses or state specifically that the amount shall not be adjusted for earnings and losses

  Effective date may not be appropriate where two assets are used to offset each other and one does not bear the market risk
- Using the time rule formula: Not appropriate for defined contribution plans unless plan administrator lacks records to perform calculation
- Calculating an equalizing payment in an uncertain market
- Calculating an equalizing payment without full information

Drafting Your MSA: Defined Benefit Plans

Still use California Family Code § 2337, then add paragraph:

The parties agree to jointly retain _________ to draft the appropriate Qualified Domestic Relations Orders to divide the community property accumulated in the (names of plans) pursuant to the "time rule" formula whereby the non-participant spouse shall receive one-half of the participant's benefits, including the normal retirement benefit, early retirement benefit, and any survivor's benefit, in the ratio that the years of participation during marriage and prior to the date of separation bears to the total years of participation earned by participant on the date the benefits become payable and are distributed to the non-participant spouse.

Example of Calculation by Plan Administrator

DOM: 1/1/05 DOS: 1/1/07

DOH: 1/1/03 DOT: 1/1/10

QDRO is entered on 1/1/09, but plan will not pay benefits until termination of employee

Gross monthly benefit on date of termination is $500 per month

Time Rule Formula:

$$50\% \times \frac{\text{Years of Participation During Marriage}}{\text{Total Years of Participation}} \times \$500$$

$50\% \times {}^{2}/_{7} \times \$500 = \$71$ per month to alternate payee

Example of Survivor's Benefit Calculation by Plan Administrator

Family Code Section 2610, *Marriage of Nice*, (1991) 230 CA3d 444, 451

Non-participant spouse is entitled to community share of survivor benefits, not necessarily the entire survivor's benefit.

DOM: 1/1/05 DOS: 1/1/07

DOH: 1/1/03 DOT: 1/1/10

QDRO is entered on 1/1/09, and participant subsequently dies with a gross survivor's benefit of $300

Non-participant spouse will not receive entire survivor's benefit, only 50% of the community portion of the survivor's benefit

$$50\% \times \frac{\text{Years of Participation During Marriage}}{\text{Total Years of Participation}} \times \$300 = \$43$$

Who receives the remaining $260?

Answer: The new spouse (whomever the participant has on the beneficiary designation form).

Pitfalls in Drafting Your MSA for Defined Benefit Plans

- Using a specific dollar amount
- Using the benefit tracing definition of community property (this is not a defined contribution plan)
- Calculating an equalizing payment without advising clients of risks (discussed later)
- Defining "community property" so as to leave out COLAs

Drafting Your MSA for Governmental Plans

Each government plan is different

Consider each government plan individually and resolve government specific plan questions before MSA is signed

Drafting Your MSA: CalPERS

Two methods of division: Shared and Separate

1. Shared: time rule at retirement
2. Separate: two separate accounts as of date of dissolution (not available if participant is already retired)

Drafting Your MSA: CalPERS

Survivor Benefits - Family Code Section 2610, *Marriage of Nice,* (1991) 230 CA3d 444, 451.

Non-participant spouse is entitled to community share of survivor benefits

Pre-retirement survivor benefits are free

Post-retirement survivor benefits: 50% free, additional must be paid for (similar to life insurance policy)

Options 2, 2W, 3, 3W and 4 provide a joint and survivor annuity that will pay a monthly benefit as long as either the member or the beneficiary is alive

Non-participant spouse must decide whether to elect for survivor benefits

Cost of survivor benefits: Who pays?

Solution: Pay in the same proportion as the survivor benefit is received.

MSA Language for CalPERS Shared

Still use California Family Code § 2337, as first paragraph, then add:

The parties agree to jointly retain _________ to draft the appropriate Qualified Domestic Relations Orders to divide the community property accumulated in the California Public Employees' Retirement System pursuant to the "shared method" whereby the non-participant spouse shall receive one-half of the participant's benefits in the ratio that the years of participation during marriage and prior to the date of separation bears to the total years of participation earned by participant on the date the benefits become payable. Non-participant spouse shall receive a portion of the pre-retirement and post-retirement survivor benefits pursuant to the ratio provided above and non-participant spouse shall bear the cost of the post-retirement survivor benefits pursuant to the ratio provided above. Participant shall elect option ___ for survivor benefits at retirement.

MSA Language for CalPERS Separate

The parties agree to jointly retain _________ to draft the appropriate Qualified Domestic Relations Orders to divide the community property accumulated in the California Public Employees' Retirement System pursuant to the "separate account method" whereby the non-participant spouse shall receive one-half of the participant's contributions and service credits earned by Participant during the marriage in a separate and distinct account set up for the non-participant spouse as of the date of dissolution.

Drafting Your MSA: CalSTRS

Two methods of division: Shared and Segregated

1. <u>Shared</u>: time rule at retirement
2. <u>Separate</u>: two separate accounts as of the date of separation (not available if participant is already retired)

Drafting Your MSA: CalSTRS

Survivor Benefits - Family Code Section 2610, *Marriage of Nice*, (1991) 230 CA3d 444, 451.

Non-participant spouse is entitled to community share of survivor benefits

Pre-retirement survivor benefits are free

Post-retirement survivor benefits must be paid for (similar to life insurance policy)

Options for 100%, 75%, or 50% are available

Non-participant spouse must decide whether to elect for survivor benefits

Cost of survivor benefits: Who pays?

MSA Language for CalSTRS Shared

The parties agree to jointly retain _________ to draft the appropriate Qualified Domestic Relations Orders to divide the community property accumulated in the California State Teachers' Retirement System pursuant to the "shared method" whereby the non-participant spouse shall receive one-half of the participant's benefits in the ratio that the years of participation during marriage and prior to the date of separation bears to the total years of participation earned by participant on the date the benefits become payable. Non-participant spouse shall receive a portion of the pre-retirement and post-retirement survivor benefits pursuant to the ratio provided above and non-participant spouse shall bear the cost of the post-retirement survivor benefits pursuant to the ratio provided above. Participant shall elect the option to receive _____% as a survivor benefits at retirement.

MSA Language for CalSTRS Segregated

The parties agree to jointly retain __________ to draft the appropriate Qualified Domestic Relations Orders to divide the community property accumulated in the California State Teachers' Retirement System pursuant to the "segregated account method" whereby the non-participant spouse shall receive one-half of the participant's contributions and service credits earned by Participant during the marriage in a segregated and distinct account set up for the non-participant spouse as of the date of dissolution.

Drafting Your MSA: TSP

TSP is a defined contribution plan through the federal government

Tip: Usually if a party has benefits under CSRS or FERS, they also have benefits with TSP

Language:

The parties agree to jointly retain __________ to draft the appropriate Domestic Relations Orders to divide the community property accumulated in the Thrift Savings Plan where the community property interest is defined as the sum of all contributions due to employment during marriage and adjusted for any earnings and losses until the final date of distribution to the non-participant spouse.

Drafting Your MSA: CSRS and FERS

Civil Service Retirement System - commenced employment with U.S. Government before 1983

Federal Employees' Retirement System - commenced employment with U.S. Government after 1983 (or went back to work for U.S. Government after 1983 with less than 5 years of service)

CSRS and FERS benefits are defined benefit plans through the federal government

Tip: Usually if a party has benefits under the TSP, then they either have benefits with FERS or CSRS or both

Drafting Your MSA: CSRS

Core Benefits Under CSRS:

1. Employee Annuity - Normally divided pursuant to time rule
2. Refund of Employee Contributions - This is in lieu of receiving a monthly pension benefit so normally best practice is to prohibit the employee from taking a refund of contributions
3. Survivor Benefits - Normally divided pursuant to time rule

   (Note: There is a cost to survivor benefits - Normally member and alternate payee share in the cost pursuant to the time rule)

Drafting your MSA: CSRS

ISSUE: OPM does not allow for the modification of a decree if made after the retirement or death of the employee. *Vaccaro v. Office of Personnel Management,* 262 F.3d 1280, 1287 (Fed. Cir. 2001)

If your MSA is too detailed regarding the CSRS benefits so as to qualify on its own as a "court order acceptable for processing," a later COAP will be rejected

Example: Member is retired and currently receiving a benefit

- MSA has all required language except leaves out survivor benefit
- Parties enter into a COAP to provide for a survivor annuity to the former spouse
- COAP will be rejected by OPM and no survivor annuity will be awarded to former spouse

Solution: File the COAP at the same time as the MSA or use general California Family Code § 2337 language knowing there are going to be issues that need to be resolved after the MSA is entered

Drafting Your MSA: CSRS

ISSUE: Survivor annuity will not be paid if Member dies after leaving work with the government and before Member applies for benefits. *Hubbard v. Office of Personnel Management, 247 F.3d 1236 (Fed. Cir. 2001)*

- Former Spouse bears the risk

- Solution: Draft MSA to require purchase of life insurance for the time period between leaving work with the government and applying for benefits

Drafting Your MSA: CSRS

ISSUE: CSRS Members will not receive social security benefits (FERS Members do receive social security)

- Currently, California law provides CSRS benefits are divided equally, but social security benefits are not divisible
- Other states allow for CSRS benefits paid to alternate payee to be offset by alternate payee's social security benefits
- CSRS Members often feel "cheated" because they will not receive social security benefits and the alternate payee will receive social security benefits
- Solution: Appellate Courts and California Supreme Court

Drafting Your MSA: COAP

- Best Practice: Enter CSRS COAP at same time as MSA/Judgment!
- Issues regarding CSRS benefits can be negotiated using leverage of entire MSA

Drafting Your MSA In An Unpredictable Economy

Drafting Your MSA in an Unpredictable Economy

401(k) and Defined Contribution Plans

- Issue: Loan amount may exceed outstanding balance
- Solution: Determine account balance and loan balance before signing Marital Settlement Agreement so this issue can be resolved
- Determine if loan is community property
- Inquire with plan administrator as to whether distribution can be made despite the loan balance

Drafting Your MSA in an Unpredictable Economy

- Issue: Equalizing Payment in Marital Settlement Agreement
- Husband has 401(k) worth $40,000 on 1/1/08
- Wife has 401(k) worth $60,000 on 1/1/08
- MSA says to equalize by payment of $10,000 from Wife to Husband and Husband shall keep his 401(k)
- MSA is signed 01/01/08
- Wife's 401(k) loses 50% in value in 2008 due to weak economy
- QDRO is not served on plan administrator until 1/1/09
- If no effective date is stated in the MSA, there will be an issue as to whether Husband will receive $10,000 or $5,000

SOLUTION: Insert an effective date for the equalizing payment into the Marital Settlement Agreement or state clearly that payment shall not be adjusted for earnings and losses in the 401(k)

- Consider: Is it always appropriate to have an effective date for equalizing payment?
  - Equalizing 401(k) with Defined Benefit Plan
  - Equalizing 401(k) with cash or other property that does not bear the risk of the market

Drafting Your MSA in an Unpredictable Economy

- Issue: Lack of Liquidity and Inability to Withdraw from 401(k) Plan due to 10% federal penalty and 2.5% California penalty
- Solution: Use QDRO to transfer money to an alternate payee to avoid 10% penalty under IRC 72(t)(2)(C)

*** Commonly used for Attorneys' Fees, example to follow

Example

- Wife owes debt (i.e., attorneys fees) of $10,000
- Wife’s 401(k) has $50,000
- Wife’s 401(k) is 100% community property
- If Wife were to withdraw her $25,000 directly from the plan, she would pay:
  - $25,000 at 28% federal tax equals: $7,000
  - $25,000 at 9.3% CA tax equals: $2,325
  - $25,000 at 10% federal penalty equals: $2,500
  - $25,000 at 2.5% CA penalty equals: $625
  - Total Taxes and Penalties: $12,450
- Leftover to Pay Debt: $12,550

Example Continued

- If instead the funds were assigned to the Alternate Payee, the Alternate Payee would pay only taxes and no penalties:
  - $25,000 at 28% federal tax equals: $7,000
  - $25,000 at 9.3% CA tax equals: $2,325
  - Total Taxes and Penalties:$9,325
- Leftover to Pay Debt: $15,675
- Savings by using Alternate Payee: $3,225

Drafting Your MSA in an Unpredictable Economy

- Defined Benefit Plan Valuations
- Risks to Advise Your Clients of Before Agreeing to a Defined Benefit Valuation:
  - Financial Solvency of the Company
  - Covered by PBGC?
  - Interest Rates
  - Inflation
  - Life Expectancy Tables
- Example: PV of $100,000 in 2030

Using 7% interest rate = $21,151

Using 2% interest rate = $65,977

Case Law: *Kennedy v. Plan Administrator for DuPont Savings and Investment Plan, No. 08-636*
January 26, 2009

- Husband had a retirement plan
- Husband and Wife divorced and MSA awarded all benefits in plan to Husband
- Husband forgot to change his beneficiary designation form and form still named Wife
- Husband died
- Despite the MSA, the plan paid the benefits to the Wife
- Supreme Court said the plan is only responsible to look to the papers it has on file, and not the MSA
- Lesson: Advise clients to check their beneficiary designation forms because an MSA will not divest the benefits to the beneficiary

Questions and Answers

For more information

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