The divorce practitioner must be knowledgeable in a multitude of areas to competently handle any case. The financial arena shelters a multitude of minefields for all of us, and few of them are as treacherous as the valuation and division of retirement benefits. Since these benefits are often the largest asset a divorcing couple must divide, careful planning is required. In order to be prepared to handle these matters with enough skill to assure your clients of receipt of all benefits due them as well as a just proportion of those benefits, one must begin with a full knowledge and understanding of the many differing types of benefit plans available.

Differentiating between the two types of plans

DEFINED CONTRIBUTION PLANS

Two different types of plans exist in the mainstream of retirement benefit plans: DEFINED CONTRIBUTION PLANS and DEFINED BENEFIT PLANS. Defined Contribution Plans (DCPs) are the types of plans where the Participant, or employee, has their own "Account Balance", even if the funds are not segregated into separate accounts for each employee. The general fund is valued at least annually and the Participant receives a statement of his/her interest in that plan. Thus, it is relatively easy to obtain an exact value of the Participant's interest in these plans. When the participant leaves the employ of the company, plan balances may be transferred to the new company's similarly styled plan, to an IRA or other such instrument of the individual or the funds may be withdrawn and paid to the individual. If the individual chooses to withdraw his/her funds before reaching age 62 ¸, the funds withdrawn are taxed at ordinary income rates AND in addition, a 10% penalty (of the entire sum withdrawn) for early withdrawal is added to the taxes paid as an incentive to keep your funds in a retirement account. Examples of types of DCPs are: Profit Sharing Plans, stock Bonus Plans, Money-Purchase Pension Plans, Thrift Plans, Savings Plans, Cash and Deferred Salary Reduction Plans, 401(k) Plans and Employee Stock Ownership Plans (referred to as ESOPs).

Defined Contribution Plans may be divided by using Qualified Domestic Relations Orders and transferring the non-participant's interest into that person's own IRA or account balance at their own employer equivalent plan. While Defined Contribution Plans are not required to provide Qualified Joint and Survivor Annuities or Qualified Pre-Retirement Survivor Annuities, securing the non-participant's interest up until the date the funds are transferred from the Participant's account to the non-participant's account is crucial. The method of providing this type of protection can be found in the sample QDRO in this issue of the Family Advocate prepared by Wayne S. Jacobsen, an ERISA practitioner in Newport Beach, California.

DEFINED BENEFIT PLANS

DEFINED BENEFIT PLANS (DBPs) with the emphasis on "BENEFIT" are more difficult to value. These plans refer to a Future Stream of Payments, based upon a BENEFIT FORMULA, as opposed to a calculable account balance, and, although funded by employer contributions calculated by the Plan's actuarial calculations, do not begin paying out until the employee or former employee retires. Typically, these plans take the average earnings of the Participant Employee over his/her last 5 years of service with the company and multiply that sum by the years of service put in by the employee and certain other factors to arrive at a monthly stream of payments to be paid to the Employee Participant upon his/her retirement. The Employee Participant may have a variety of payout methods to select from, including payments made over a single life (i.e. for as long as the former employee lives); a joint and survivor annuity (for as long as the former employee lives and, independent of the former employee's life, for as long as the joint annuitant lives); a 10 year guaranteed payment etc. Each of the choices offered will affect the monthly annuity paid. A Joint and Survivor Annuity, because it is to be paid over the risk of 2 lifetimes will necessarily be a lesser sum than a single life annuity. Under the Retirement Equity Act of 1984 (REA), both ERISA and the Internal Revenue Code were amended to provide that Qualified Retirement Benefit Plans (such plans include: Defined Benefit Plans, Money Purchase Plans and Target Benefit Plans) must pay certain benefits to a married plan participant and his/her spouse. If the participant dies BEFORE retiring, this benefit is called a Qualified Pre-Retirement Survivor Annuity (QPSA), and if the participant dies AFTER retiring, the benefit is called a Qualified Joint Survivor Annuity (QJSA). These benefits are crucial to secure when dividing Defined Benefit Plan interests when representing the non-participant spouse. Not including surviving spouse language in a Domestic Relations Order would be putting the non-Participant spouse's interest at risk of loss and would be tantamount to malpractice. This concept is discussed in Daniel N. Janich's article entitled, "QDROs and Surviving Spouse Protection: What happens When the Participant Remarried?" elsewhere in this Family Advocate issue. This issue of the Family Advocate also contains two sample QDROs prepared by ERISA expert Wayne S. Jacobsen of Newport Beach, California. Waiver of a QPSA or QJSA require strict compliance with the REA rules and are discussed in detail in Ann Pachciarek and Julie LaEace's article on Waiver of Interests in Qualified Retirement Plans in Pre-Marital Agreements elsewhere in this issue of the Family Advocate.

Valuing the defined benefit plan interest

The concept of valuing the Participant's current interest in a Defined Benefit Plan involves determining how much money would be required to be put into a bank account TODAY in order to provide enough money to pay the monthly sums for the lifetime of the Participant at the time the employee-Participant retires in the future. This valuation process is predicated upon a number of assumptions, such as the employee-Participant's age of mortality; future interest rates adding to the value of the funds, etc. To arrive at a PRESENT VALUE of the DBP, you will likely call upon an expert witness, such as a CPA or an Actuary to give you a report of value. How this valuation is accomplished and how one works with such an expert is covered by Sandor Goldstein's excellent article included elsewhere in this Advocate Issue.

Negotiating the division of a DBP should include more than merely dividing the annuity payment by use of a Qualified Domestic Relations Order. There are other pieces of the benefits to divide, such as surviving spouse benefits; early retirement buy-out offers; cost of living adjustments (COLAs); and other subsidies.

Understanding certain special types of plans

IRAs come in many varieties today. A simple IRA is available to an individual who is not a participant in an employer sponsored plan or to the individual who has less than $ _______ set aside by their employer in that particular year. Individuals can place $2,000 annually into an IRA, whether or not they have been employed in any capacity during the year.

SEP IRAs can be instituted by any C or S corporation, partnership, sole proprietorship or self-employed individual. The employer can restrict eligibility to those over 21 years. Some part-time workers under a defined salary limit can be ineligible from participation. Union workers under a collective bargaining agreement can also be ineligible from participation. Ineligibility can also be limited to those who have worked 3 out of the last 5 years. The contributions, made solely by the employer and directly into each individual's IRA, can vary from year to year and can even be discontinued, so long as contributions and discontinuation are allocated in a non-discriminatory manner. Each individual employee can receive up to 15% of their pre-tax income into the plan with an annual maximum. The maximum is adjusted annually for inflation and is currently about $24,000. Loans are NOT permitted in this type of plan. The contributions are tax deferred until withdrawal.

Roth IRAs are NOT tax deferred funds. These are AFTER TAX dollars deposited into a Roth IRA. All growth in the account is tax-free thereafter.

Educational IRAs are set up with AFTER TAX dollars for the benefit of children under the age of 18. Funds can be removed from the account TAX FREE after the child attains age 18 if used for higher educational expenses.

Defined contribution styled plans

401(k) Plans are retirement savings plans that are funded by pre-tax EMPLOYEE contributions and may include matching contributions from the employer. Funds grow tax free until withdrawn. These types of Defined Contribution Plans may be utilized by for-profit and many kinds of tax-exempt organizations, and the employee is often free to direct his/her own investments. These funds are not accessible until the participant reaches age 59 ¸ , except through payments of taxes and penalties. The plan funds are not guaranteed by the Pension Benefit Guarantee Corporation. Employer contributions may not vest immediately. Some of the limits of annual allowable contributions depend on the number of lower paid employees participating in the plan. Plans vary and certain plans allow for post tax earnings to be contributed to the participant's account; however, such accounts are 401(a) employee savings plan accounts. Employee savings plans allow for tax-free growth until withdrawal of after tax monies put into the account. 401(k) accounts are limited to employee contributions of $10,500 in 2000 (again, this sum is adjusted annually for inflation) and this dollar limitation applies to the total sum contributed by the employee, no matter how many different employers that individual worked for in any given year. The annual limitation on total contributions to all employee types of plans adjusts annually, but is approximately $30,000 or 25% of the employee's total annual compensation, which sum cannot exceed the dollar maximum. 401(k) plans usually allow access to funds through loans, limited to a certain dollar amount of approximately $50,000 which must be paid back with interest over 5 years, although that payback period can be extended to 15 years for the purchase of a principal place of residence or an intended principal place of residence. One benefit of a 401(k) plan is that if an employee retires or is "separated from service" during the year they reach age 55 or more, the participant can withdraw any amount from his/her account without penalties. Additionally, after reaching age 59 ¸, the participant, even if still employed, may begin withdrawing funds so long as the plan allows same. Minimum withdrawal rules, being 10% kick in beginning when the participant reaches age 70 ¸ if the participant is no longer working at the company.

403(b) Plans are structured like 401(k) Plans; however, the 403(b) plans are not "qualified plans" under the tax code. Rather, such plans are Tax Sheltered Annuity Arrangements offered only by public school systems and other tax-exempt organizations. 403(b) Plans are not limited by the anti-top heavy rules of 401(k) plans. As such, there is no limitation imposed by "low earning" or other individuals participating in the plan other than the participant. Employer contributions, if any, have different limitations than under 401(k) plans. The 10% early withdrawal penalty and the 15% excise tax for excess annual contributions apply to both 401(k) and 403(b) plans. Such plans include State Teacher Retirement System Plans and such venerable institutions as TIAA-CREF.

TIAA-CREF is so often encountered, it is important to take a moment to look at its features. The TIAA traditional Annuity guarantees to preserve invested principal and to pay at least a contractually specified interest rate, and holds the possibility of dividend payment. The TIAA Real Estate Account and all CREF accounts are VARIABLE ANNUITIES that offer no guarantees on principal or investment returns. CREF investments are directed by the participant into one of 8 types of accounts: stocks; global equities; growth; equity index fund; social choice fund; bond market; inflation-linked funds and a money market fund. TIAA-CREF also offers participants the ability to participate in SRAs or Supplement Retirement Annuities in order to provide more retirement funds. Often such employees have little or no individual Social Security Benefits because they have not worked in the private sector long enough to secure such benefits. Both TIAA and CREF accounts are divisible by QDRO; however, the plan provides its own form QDRO for use and it is wise to have the division decisions made between the client and his/her financial advisor rather than the attorney.

457 Plans are also a form of a non-qualified plan, but is designed for deferring compensation for employees of states, counties, cities, agencies and other political agencies. The purpose of these plans is to provide a tax favored avenue for such employees to save for their own retirement. The employer contracts with the employee to defer compensation to some future date for currently performed services of the employee and this "promise to pay" is not secured by an institution such as the PBCG. Annual salary deductions are limited to $7,500 or 33 1/3% of salary, whichever is less. Payments are taxable as ordinary income and distributions are not allowed to be rolled over into an IRA. Distributions occur upon retirement, terminations of

employment or death. Some plans may have an "extreme financial hardship" withdrawal provision. Virtually every state has its own Public Employees Retirement System or Systems and the rules for same are found in each state's statutes. These plans are not governed by ERISA and are instead ruled both by state law and the provisions of the Internal Revenue Code. Division can be extremely difficult, if not impossible. Many of the provisions negotiated for ERISA covered plans, such as "surviving spouse" designation may be inapplicable in these plans, but each one must be studied thoroughly.

SEPs or Simplified Employee Retirement Plans can be set up at a bank or brokerage house based upon a pre-printed form plan document which requires separate accounts for each participant. Each participant has their own account balance and there is no waiting period for coverage. Employees who have not worked 3 out of the last 5 years need not be covered in these plans. SEPs may be set up and funds contributed in the next taxable year up through the date that the tax return is due.

Keough Plans are either Money Purchase Plans or Profit Sharing styled plans. The Money Purchase Keough allows up to 20% of earnings, with a $30,000 annual maximum contribution to be contributed to the participant's account balance. These contributions must be made EVERY YEAR. The Profit Sharing styled Keough allows for a lesser maximum percentage of earnings to be contributed and contributions cannot be based on earnings over $150,000 annually. Annual percentage variations are allowed on Profit sharing styled Keoughs. Age 21 can be a minimum requirement for plan participation and employees who have not worked for 1 year may be excluded along with some part-time employees. Keough plans can limit vesting to 3 to 5 years or, if desires, a vest schedule can be strung out over 7 years. Employees who leave before full vesting only take vested benefits with them. Keough plans must be set up before year end, although contributions may be made after year end up through the date the tax returns are due.

The hybrids

There are certain types of accounts which have characteristics of Defined Contribution Plans, yet are also akin to Defined Benefit Plans. Such plans include Cash Balance Pension Plans; Pension Equity Plans; Life Cycle Pension Plans and Retirement Bonus Plans; Floor-Offset Pension Plans; Age-Weighted Profit Sharing Plans; New Comparability Profit Sharing Plans and Target Benefit Plans.

In a Cash Balance Plan, each participant has an account that is credited with a dollar amount that resembles an employer contribution and is determined by a percentage of the participant's pay. Interest is paid to each account. Typically, benefits are paid as a lump-sum distribution or as an annuity. These plans provide Defined Future Payable Benefits rather than employer contributions. While each account expresses current lump-sum values of the participant's accrued benefit, in actuality, the account is merely a bookkeeping device. Actuarial valuations control employer contributions to the participant's account rather than the actual contributions made to each account. Interest is credited at a specified rate and is UNRELATED to the investment earnings of the employer's pension trust. The annual limits for contributions are applied to the annuity equivalent of the cash balance account, rather than the amount added to the account each year. Loans are permitted under these plans, but because this would be difficult to administer, these plans do not usually allow loans.

Pension Equity Plans, like Cash Balance Plans define benefits in terms of a current lump-sum value rather than a deferred annuity. The Pension Equity Plan is a final average lump sum valuation determination and it does not have individual accounts to which interest is credited annually. Each year of service credits the employee with an ever increasing percentage that will be applied to their final average earnings. Both lump sum benefits and annuities are methods of payment to the employee upon retirement, depending upon the provisions of the plan.

Life Cycle Pensions Plans and Retirement Bonus Plans: Like the Pension Equity Plan, Final Average Salary is multiplied by years of service credits that are converted into a percentage figure.

Floor-Offset Pension Plans are actually 2 plans that are interrelated. The FLOOR plan is the defined benefit plan and the BASE plan is the Defined Contribution Plan. The Floor Plan establishes a minimum benefit level that is dependent on the employer's objectives and constraints. If the defined contribution plan provides a benefit that equals or exceed the minimum established by the defined benefit floor plan, the participant receives the balance in the defined contribution account and NO benefit is payable from the floor plan. The level of contribution from the floor plan will depend upon the benefits payable from the defined contribution plans ability to meet or exceed the established minimums.

Age-Weighted Profit Sharing Plans provide greater benefits to older employees and are often used by smaller companies. These plans have an age factor weighted into the formula allocating profit sharing funds to individual accounts rather than being based solely on the percentage of the employee's salary.

New Comparability Profit Sharing Plans divide employees into separate allocation groups to provide larger percentage contributions for certain select employees.

Target Benefit Plans set a "TARGET" benefit for each participant at normal retirement age, which is usually age 65, using a defined benefit plan formula. Employer contributions are determined actuarially. Unlike a traditional defined benefit plan, the target benefit is NOT GUARANTEED. Individual accounts are established for each participant and investment decisions are usually left to the employee, whose account gets the interest or losses generated by those investment decisions. The employer only has an obligation to make the contribution required by the plan formula. It is the employee who runs the risk of the investments yielding the benefits anticipated by the investment strategy.

Non-ERISA covered plans

Up to this point, virtually all plans discussed were ERISA plans or ERISA styled plans. ERISA plans allow the employee to have PRE-TAX dollars put into an account and grow TAX FREE until withdrawal. Non-ERISA covered or styled plans do not have such benefits; nor are such plans guaranteed by coverage from the PBGC.

TOP HAT PLANS -- are unfunded plans maintained by employers primarily for the purpose of providing deferred compensation for a select group of management or highly compensated employees. These plans are designed to attract and keep key employees and executives. Because these plans are unfunded, tax forms are not filed annually. Finding these plans is difficult without disclosure or very specific discovery requests to employers and employees alike.

SUPPLEMENTAL EXECUTIVE RETIREMENT PLANS (SERPs) -- are unfunded plans maintained by employers to reward and attract key executives. Top Hat Plans are one such plan. The underlying assets in SERPs are considered corporate-owned and are thus available for use by owners and creditors of the corporation. When corporations are potential merger or takeover candidates, or, at times when facing bankruptcy, a single or group fixed annuity is purchased by the corporation to secure these benefits for the key employees. Again, specific requests for such information from the corporation and the employee as well as the Benefits Director would be the avenue for locating such a valuable asset.

RABBI TRUSTS -- are security devices, akin to an escrow account, which contains segregated funds to be used for the purpose of securing "unfunded" employer obligations to employees under one or more of its non-qualified plans. It is an irrevocable trust established for the benefit of the participant by the employer. Again, specific language in discovery requests to employers and employees is required to ferret out these trusts.

Railroad retirement plan

Military Retirement Systems and the Federal Employees Retirement System (FERS) are discussed elsewhere in this Family Advocate issue in an article by Mark Sullivan of Charlotte, North Carolina. There is one other type of plan not elsewhere discussed: the Railroad Retirement Plan, another non-ERISA plan. This plan has 2 types of benefits: Tier I, which is equivalent to Social Security and Tier II, which is a defined benefit styled plan. Only Tier II benefits can be divided and these benefits CANNOT be used for spousal support or child support collection. The Railroad Retirement Board provides its own form G-177d with model language for inclusion in a Judgment of Dissolution of Marriage, as no separate instrument, such as a Domestic Relations Order is required to divide these benefits. Parties must be married for 10 years immediately preceding divorce before the spouse can obtain any benefits.

The importance of section 72(t)

The Internal Revenue Code provides a special tax exception for the distribution of ERISA pension benefits prior to age 59 ¸ to a spouse or former spouse when incident to divorce via section 72(t), which provides that the 10% penalty on the entire sum withdrawn is waived. The taxes on the sum withdrawn are not waived and must be paid over and above the 20% withheld by the plan and forwarded to the IRS. Practitioners should check their local state taxation rules as a number of states do not tax retirement distributions.

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