Don’t Let Divorce Derail Your Retirement Plans

Understanding your options before, during, and after your marriage

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Retirement is one of those moments for which one spends a lifetime preparing. Divorce will impact your journey to retirement. The more knowledgeable you are about your retirement benefits and those of your spouse, the smoother that journey will be.

Retirement accounts are meant to replace employment income when your work life ends. These types of accounts allow people to accumulate wealth with certain tax benefits during the accumulation process. There also are penalties if these accounts are needed earlier than planned. The variety and complexity of retirement plans offer unique challenges when a couple must separate their marital assets during divorce. Retirement benefits accumulated during marriage are probably subject to division.

Retirement plan basics

There are two main types of retirement plans: the defined benefit plan and the defined contribution plan. When most people think of retirement plans, they are usually thinking of **defined contribution plans**. A defined contribution plan is an employer-sponsored plan with an individual “account” for each participant. The benefit is solely based on contributions made by either or both the employee and the employer into an individual account and the investment gains of those funds.

Types of defined contribution plans include Individual Retirement Accounts (IRAs), 401(k) and 403(b) accounts, and profit-sharing plans. These types of plans are normally not taxed at the time of contribution. The funds may not be withdrawn without penalty until the investor reaches age 59½. The IRS limits the maximum amount that can be contributed to these types of accounts tax-free at the time of contribution.

Another type of defined contribution plan is a Roth IRA. This type of plan is initially funded with after-tax dollars; however, the earnings are tax-free as are the distributions. You can use your contributions to a Roth IRA account at any time, and withdrawals are tax- and penalty-free. However, any use of the earnings until retirement will likely become a taxable event (that is, the IRS will view those earnings as additional income for tax purposes). In 2014, you can contribute up to $5,500 to a Roth IRA so long as your adjusted gross income is less than $114,000. Roth IRAs often are used to fund college as is discussed later in this article.

A **defined benefit plan** often is referred to as a “pension plan.” These types of plans calculate benefits using a fixed formula to calculate monthly lifetime payments that typically factor in final pay and number of years of service with the employer. In a defined contribution plan, the payout is dependent on both the amount of money contributed and how well the investment performed. Retirees choose between single life annuities, which provide regular payments until the death of the pension recipient, and joint and survivor annuities, which continue to make payments to the spouse or ex-spouse after the death of the retired worker.

A single life annuity generates a higher monthly payment, whereas a joint and survivor annuity generates a lower monthly payment due to the insurance against the risk that the retiree will die before the spouse or ex-spouse, leaving the survivor with insufficient income. Consult a financial advisor when deciding which type of annuity is appropriate for you.

Certain **hybrid plans** also exist. Hybrid plans combine the features of defined benefit and defined contribution plans. A typical hybrid design is the cash balance plan where the employee's face value account balance grows by some defined rate of interest and annual employer contribution.

When dividing retirement accounts, many things must be examined. The accounts must be valued; contributions made prior to the marriage must be calculated; and how the accounts are going to be split or traded must be determined. To complicate things even further, the laws on how these assets are treated vary from state to state. Despite these variations, there are certain constants that will be helpful to keep in mind.

How your account is valued

A defined contribution plan is much easier to value and, therefore, easier to split. Defined contribution plans have a value as of a certain date, which can be divided as either a percentage or dollar amount to the other spouse. Care must be taken to divided increases or losses that occur between the valuation date and the date of distribution.

A defined benefit plan is another story altogether. It is valued as a future stream of payments based on a benefitformula. Thus, many defined benefit pension plans will not pay a lump-sum amount and will only pay a spouse on a monthly basis for a lifetime, starting around retirement age.

A younger spouse will receive a discounted sum if the former spouse begins taking payments earlier than when payments normally would begin. This may make it more desirable to consider an offset of some type. An offset would mean accepting some type of other property instead of a share of the future monthly pension payments.

If considering an offset, it is a very good idea to have a professional value the defined benefit plan to ensure that you are getting something of equal value for this asset. The value generally is determined through an actuarial analysis of the pension plan. Even when valued by a professional, a future pension value and even the right to a pension is not a sure thing.

Although figuring out how best to divide a pension benefit is very difficult, you may find some comfort in knowing that the Pension Benefit Guarantee Corporation (PBGC) ensures against a pension fund's inability to pay the promised pension.

How your account is "divided"

When dividing assets, you will consider whether to divide retirement accounts or negotiate a trade-off of other types of assets such as a home. Be cautious when contemplating a trade-off of this type. Remember that defined contribution retirement accounts will be taxed as income when funds are withdrawn, so they have a "pre-taxed" value, whereas a home net value is in after-tax dollars.

A $100,000 IRA is not equal to a home with $100,000 of equity. A home is more likely to have ongoing and unexpected expenses, and the future value can be uncertain. The potential appreciation value of a home and the tax consequences of any asset must be considered when selecting between a division or trade-off. A house is not necessarily a tax-free asset, since it is possible to incur capital gains taxes upon the sale of the house.

Marital property consists of most property acquired during a marriage, anything

purchased with money earned during the marriage, and anything acquired with the proceeds of marital property. However, what constitutes marital property is very state specific. Consult with your attorney to learn more about the laws of your state.

Retirement accounts can be both "marital" and "nonmarital" in nature. This can complicate the division process. With a defined contribution plan, it often is possible to determine the account balance at the time of the marriage. A good piece of advice upon remarriage is to retain a copy of your last monthly statement prior to remarriage and all year-end statements thereafter. In this way, you can determine which portion is marital and subject to division.

When it is not possible to ascertain the balance at the time of the marriage, a formula can be used to determine the nonmarital portion of an account. Simply multiply the average yearly contribution times the number of years worked prior to the marriage. This is, however, an imperfect method, because, for example, a premarital portion can easily be overestimated in a long marriage. Commonly, as employees age their incomes, along with their contributions to a 401(k) or IRA, increase. Therefore, calculating the value based on an average contribution can greatly overestimate contributions made early in one's life.

Defined benefit plans also can be both "marital" and "nonmarital." The determination of the nonmarital portion is a bit more complicated when valuing this type of asset. Many states base the portion to be divided on the percentage of time that the employee spouse participated in a plan during the marriage. This provides a percentage of the future benefit that is marital. When valuing and dividing a pension plan, it is important not to forget benefits that exist outside of the obvious "value." These benefits can include things such as cost-of-living adjustments (COLAs), surviving spouse benefits, and early retirement buyouts.

Social Security

You may be entitled to a portion of your spouse's Social Security benefits, including survivor benefits, as long as you have been married for ten years, your work credits do not exceed half of your spouse's, and you do not remarry. If you are in the process of divorce and are approaching your ten-year marriage date, you may wish to delay the divorce. Once you pass the ten-year mark, you are entitled to these benefits with no negative effect to your spouse. Some states consider this an offset against accumulation during marriage. Ask your lawyer for clarification in your state.

During divorce…

- **Continue voluntary contributions.** Divorce is a process and not an instant event. During the process, it may be beneficial for some to continue to contribute to voluntary retirement accounts, whereas others may choose to temporarily cease their retirement contributions. In some states, marital property continues to accrue after separation until the divorce decree is entered. In others, marital property stops accruing on the date of separation or date the divorce was filed or served. In states where the value of marital property increases up until the date of divorce, halting contributions may keep from growing your spouse's share at your expense. However, since many employers match contributions, you could be forgoing a substantial amount of money by ceasing contributions.

  Another consideration is whether your state is a community property state where property may be divided equally. If you reside in an equitable distribution state or a community property state where property is divided equitably upon divorce, "equitable" does not necessarily mean "equal." Your spouse may receive more than 50 percent of your retirement accounts at the time of divorce.

- **Using a QDRO to divide accounts.** The actual process of dividing retirement accounts is important and complicated. Many factors must be considered. The court must adhere to federal guidelines when dividing some accounts, such as 401(k) or pensions, and state laws dictate the division of other plans such as IRAs. Your settlement agreement must be specific as to how these accounts will be split and how funds will be transferred.

  The division of a 401(k) or pension account requires what is called a Qualified Domestic Relations Order (QDRO). A QDRO allows for a portion of the retirement account to be withdrawn without penalty and deposited into the other spouse's existing or newly created retirement account, but only once it has been accepted by the plan administrator. Following up to ensure acceptance by the administrator is critical. It also is very important to make sure that both the settlement agreement and the QDRO are drafted to protect and account for gains and losses in the account. Division of a traditional IRA or a Roth IRA does not require the use of a QDRO. Avoiding the triggering of unnecessary taxes or penalties is the goal you want to achieve.

- **Paying expenses with retirement funds.** A QDRO allows a divorcing spouse under age 59½ a one-time withdrawal of money from certain accounts without incurring the standard 10 percent early-withdrawal penalty. The catch is that this withdrawal must be performed through a QDRO. This can be very useful when needing to pay unavoidable expenses such as attorney's fees incurred in the divorce. However, remember that this money will eventually be needed to live on. Only amounts absolutely necessary should be withdrawn. Also remember that the funds withdrawn will count as taxable income for the year.

  Another method of withdrawing funds is to borrow no more than half of the account balance if your plan so allows. The maximum allowable withdrawal is $50,000. These monies must be repaid in no less than equal quarterly payments over five years (15 years if borrowed to purchase a home or second home) with a reasonable interest rate being paid.

- **Funding higher education.** The other opportunity to withdraw money from a traditional or Roth IRA without a 10 percent penalty is for a distribution for higher education. If, at some point, you hope to help your children, or even grandchildren, with higher education expenses, it may be a good idea to set aside an IRA for this purpose. Rather than divide an IRA account, you may want to allocate this account for future higher education expenses, even if you are not over the age of 59½.

- **Changing beneficiaries.** Another important step during the divorce process is to change retirement account beneficiaries immediately upon entry of the divorce judgment. No matter what your state law is, federal law is supreme. Recent cases have made it clear that when it comes to federal retirement plans, such as pensions and even life insurance benefits, a change-of-beneficiary notice is mandatory. Put this on your "***absolutely must do***" list. The only way to be sure that a former spouse is removed as a beneficiary from an account is to formally change the beneficiary listed on the beneficiary designation form.

After the divorce…

Before finalizing your divorce, make sure that all documents needed to divide the necessary accounts are in order and "pre-approved." Discuss this with your attorney. If you will be using a QDRO to divide an account, a draft QDRO should be sent to the plan administrator for pre-approval. It is important to make sure that there will be no

surprises after the divorce has been finalized and that all accounts can be allocated as anticipated. There may be a problem with unfunded or excess plan accounts. It is very rare that an account of this type will accept any domestic relations order for division. If an account of this type exists, your attorney will need to be creative about the allocation. Either a trade-off or division of the account once it becomes funded at a later date will be necessary. Securing the latter method is not easy.

Once the divorce is complete and a judgment has been entered, you may think you are done. This is not always the case. Make sure that you or your attorney follow through with the division of retirement accounts. The QDRO, which hopefully was pre-approved, needs to be submitted to the administrator in its final form. Do this immediately following entry of the judgment. You do not want to find years down the road that a QDRO was either never submitted or not approved and then have to deal with many potential complications.

During the divorce, it is always helpful to be able to ask informed questions to ensure that you get the best possible outcome. This discussion of retirement plan options should better prepare you to ask those questions. A knowledgeable attorney will be able to answer your questions in more detail and walk you through the process and the specific laws of your state. FA

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