401(k) and Other Defined Contribution Plans in Divorce Mediation

(by Anju D. Jessani, MBA, APM – Accredited Professional Mediator)

With the recent unprecedented drop in the stock market, some investors have seen their portfolios decimated. From 3/31/00 to 3/31/01, the Dow Jones Industrial Average which represents the price of 30 large well-established companies fell from 10,922 to 9,879 (9.6% decline), while the technology heavy NASDAQ which serves as an index for newer, over-the-counter stocks, fell from 4,573 to 1,840 (59.8% decline).

On the client side, I have seen a number of clients who had negotiated in the divorce process to receive a percentage of their spouse's defined contribution plans (i.e., 401(k), 403(b), Thrift Savings Plan, Investment and Savings Plan, etc.), surprised that the dollar amount they received was less than they anticipated, because of the drop in asset values. Part of the problem is that while clients were doing the necessary paperwork to comply with their companies' legal requirements to transfer funds to the alternative payee, the monies were kept in investments tied to stock market performance. While hindsight is 20/20, and there may be signs that the market has found a bottom, I believe there is a benefit to clients for mediators to provide focus on the asset allocation mix of their clients' defined contribution plans.

In this article, I will provide an overview of how defined contribution plans work and how they differ from traditional defined benefits plans, offer an explanation of typical investment options within defined contribution plans, and will also discuss mediators can better assist their clients address the issue of asset allocation when one of the parties will be receiving a percentage of the other party's defined contribution account as part of the divorce settlement.

Traditional Pension Plans AKA Defined Benefit Plans

Traditional pension plans, also known as defined benefit plans have a formula by which an employee's pension payout is determined at retirement, usually based on pay and years of service. There is one pool of funds from which benefits are paid, and the individual employee has no direction in the investment of plan assets. At any given time, there is an exact defined amount an individual would receive upon retirement once he or she is vested in the plan (e.g., $1,000 a month starting at age 65). Were they to divorce, their spouse might be entitled to some part of the marital portion of this plan, at the time of the employee's retirement, based on the instructions provided in a domestic relations order, usually prepared around the time of the divorce.

Defined Contribution Plans

A defined contribution pension plan by contrast, has an individual account for each participant. Some companies and organizations will match some percentage of employee contributions. The most popular form of the plan is the 401(k) which provides private sector employees the opportunity to make contributions up to a set amount, which are tax-deferred until the money is liquidated. The 403(b) plan for charitable and educational organizations is very similar. This means that in most cases, federal, state and local taxes on money invested, along with taxes on investment earnings are deferred until an employee takes a distribution or withdrawal. You should also note that if you receive some part of the marital portion of your spouse's plan, you also usually inherit the deferred tax obligation on your portion of the proceeds.

If you receive distributions from 401(k), 403(b) plans and some of the other defined contribution plans before you reach age 59.5 years, in additional to deferred taxes, your distributions are usually subject to an additional early distribution tax of 10%. However, the early withdrawal tax does not apply to distributions from a qualified retirement plan (other than an IRA), to an alternate payee under a qualified domestic relations order (QDRO). This is an important point to note in divorce cases.

Most defined contribution plans allow the participant to make investment choices from investments provided by the plan. Participants usually receive quarterly reports summarizing contributions, gains and losses, and account balances. As with the defined benefit plan, in the event of divorce, their spouse might be entitled to some part of the marital portion of this plan. In contrast to the defined benefit plan, this transfer is usually made to the alternate spouse around the time of the divorce, again based on the instructions in the divorce agreement and/or domestic relations order. While most clients choose to defer taxes and deposit their funds in a Rollover IRA, some clients do choose to liquidate their proceeds.

Investment Options in Defined Contribution Plans

There is no certainty about the amount of accrued benefits you can expect on retirement from a defined contribution plan because the value of the account will depend on the amount of the contributions along with the performance of these investments. A typical defined contribution plan might allow participants to choose between a money market fund, a bond fund, a stock fund, an international stock fund, and company stock; some plans offer more than twenty investment options. The employee chooses how to allocate his/her account balances between these funds as well as how future contributions to the plan will be allocated. A discussion of the typical characteristics of these types of funds, from lowest to highest risk exposure, follows:

- Money Market or Cash Reserve Fund. The least risky investments are those that seek capital preservation. They usually invest in high-quality money market instruments with maturities under a year. Individuals who choose capital preservation trade off higher potential long-term returns for the peace of mind that their money is relatively safe. By investing in a group of instruments through a fund rather than any one issue, you lower your risk of exposure to any one company's performance.

- Bond Fund. Similar to an IOU, a bond is an agreement to repay a debt and is generally issued by a government or corporation. When you invest in a bond, you lend the issuer money, who then pays you regular interest payments, and repays the principal at a specified date. Because bond prices move in the opposite direction to interest rates, bond prices can sometimes lose value. Companies that are more creditworthy usually pay lower interest rates. Again, by investing in a group of bonds through a fund rather than any one issue, you lower your risk of exposure to any one company's performance.

- Stock Fund. Stocks represent ownership in a corporation. US large company stock funds are generally more conservative than small, international, or emerging market stocks. Additionally, as some of the large stocks pay dividends, they provide an income stream than can help to cushion to protect principal and lessen the effects of adverse market conditions. Again, by investing in a group of stocks through a fund rather than any one issue, you lower your risk of exposure to any one company's performance.

- International Stock Fund. International investments will also be affected by fluctuations in currency exchange rates, and some countries may experience political or social instability. In addition, accounting and reporting standards may be less stringent. Along with these added risks, comes the potential for higher long-term returns. Again, by investing in a group of stocks through a fund rather than any one issue, you lower your risk of exposure to any one company's performance.

- Company Stock. Company stock typically carries significantly higher risk than other investments because company stock is undiversified. You put all your eggs in one basket when you invest in only one stock. To illustrate market volatility even among the blue chips, during the 3/31/00 to 3/31/01 period, Lucent went from 62 to 10 (83.9% decline), while Pfizer went from 36.6 to 41 (12% increase).

Financial experts will tell you that market conditions are always changing, past investment performance cannot be viewed as a predictor of future performance, and that you have to take a long-term perspective. However, if you are depending on receiving a certain amount of money from a divorce from your spouse's defined contribution plan, you need to first understand where the money is invested and whether you have too much exposure to market risk if short-term conditions and plan values change. Once you have this information and understand the current portfolio mix, you can then take steps to change the allocation.

Accommodating the Non-Employee Spouse's Risk Perspective

While the employee spouse has control of the plan, I have found most of my clients have been willing to accommodate their spouse's different financial objectives, and have been willing to move money earmarked for the spouse to investment options that are suitable for their spouse's risk tolerance. By realizing that clients understand the risks in the asset allocation of the other spouse's defined contribution plan, the mediator can then assist the clients in including the appropriate language in the Memorandum of Understanding (MOU).

If the parties are in agreement on asset allocation mix, the mediator may want to include the following clauses in the MOU regarding the intention of the parties that an alternate payee receive a benefit from the plan from (West's Legal Forms):

- The WIFE/HUSBAND shall receive $ (Dollar Amount), adjusted for allocable gains or losses for the period between x/x/xx and the date of distribution; or

- THE WIFE/HUSBAND shall receive (Percentage Amount)% of the Participant's vested account balance under the plan determined as of x/x/xx, adjusted for allocable gains or losses between the dates y/y/yy and the date of distribution.

Alternatively, the parties could agree that the spouse will receive money from a specific fund from the 401(k). So, for an example, the wife may decide that she wants to receive all her money from the low risk money market account, adjusted for gains and losses, rather than from each of the funds her husband is invested in.

If the employee spouse is unwilling to move the funds during the interim period, the mediator may want to suggest language that guarantees the alternate spouse a fixed amount on money, no matter how the market performs. In this situation, it may be wise to include this clause (also from West's Legal Forms):

- The WIFE/HUSBAND shall receive $ (Dollar Amount), unadjusted for any allocable gains and losses.

<u>Getting Assistance from Financial Experts</u>
My suggestion to mediators who have clients with significant defined contribution plans in which the other spouse is receiving a portion of the plan pursuant to the divorce, is to refer their clients to financial experts for their help.

Information provided by:

Please contact us at ajessani@dwdmediaton.org for more information