What does a divorce attorney need to know about retirement plans to settle or try a case? This article is not intended to make you an Employee Retirement Income Security Act of 1974 (ERISA) expert, but to familiarize you with basic information regarding retirement plans.

It is acknowledged that the major assets that are divided when parties divorce are the retirement plans and the marital residence. Despite the recent economic downturn, a substantial portion of many marital estates can still be found in retirement benefits. Considering that the value of real estate has also dropped, retirement benefits may be the main asset still available to divide when there is a divorce. A couple may have a number of different retirement plans to divide up when they divorce.

The State of Illinois recognizes that retirement benefits of all sorts are marital assets that are subject to division between spouses. In order to effectively value and divide up the retirement benefits, it is important to understand the differences between the various types of plans.

There are two main categories of retirement plans controlled by ERISA law: 1) Defined Contribution Plans and 2) Defined Benefit Plans. The plans operate in substantially different ways. It is important to understand the differences between the types of plans and how those differences affect the valuation of the retirement plans. Other sources of retirement plans are those sponsored by government entities and supplemental plans.

**Defined Contribution Plans:** A defined contribution plan focuses on the contributions to the plan. A defined contribution plan maintains an individual account with a balance that can be determined for each participant. The account balance will be derived from employee or employer contributions and forfeitures, and market gains and losses on same. The defined contribution plan will not promise a specific benefit amount at retirement. The Participant receives the balance in their account at retirement (or other triggering factor).

**Features of Defined Contribution Plans:**

a) The employee has an individual account and can control the investments within that account.

b) The employee assumes the investment risk.

c) The funds in the account are tax deferred.

d) The accrued benefit is the account balance which may include forfeitures and employer matches.

1 In re Marriage of Hunt, 78 Ill.App.3d 653, 397 N.E.2d 511 (1st Dist., 1st Div. 1979); In re Marriage of Uluhogian, 86 Ill.App.3d 654, 408 N.E. 2d 107 (5th Dist. 1980); In re Marriage of Pieper, 79 Ill.App.3d 385, 398 N.E. 2d 868 (1st Dist., 4th Div. 1979); In re Marriage of Hackett, 113 Ill.2d 286, 497 N.E. 2d 1152 (1986).

2 An employee who acquires benefits in a retirement plan is called the participant. For the types of plans discussed herein, the way that an employee acquires benefits if through employment. How long the person needs to work to qualify for benefits may differ depending upon the type of the plan.

3 Forfeitures occur when an employee leaves the employ before becoming 100% vested or if the employee cannot be located. Funds that are forfeited are reallocated to other participants or used to defray plan costs. 26 USCA §411(a)(3).
e) The amount of the employer contributions may either be discretionary or mandatory.
f) The value of the plan is the sum on the participant’s account statement.
g) Vesting may be immediate or over a 6 year period (or shorter period).4
h) Because the investment risk is on the plan participant, a defined contribution plan is not covered by the Pension Benefit Guaranty Corporation (“PBGC”).

Defined contribution plans have become more popular with employers because all the investment risk is shifted to the employee. These plans also have lower administrative costs than defined benefit plans.

The following are several variations of defined contribution plans:5
1) Profit Sharing Plans
2) Stock Bonus Plans
3) Money Purchase Pension Plans
4) Employee Stock Ownership Plans (ESOPs)
5) Target Benefit Plans
6) 401(k) Plans
7) Simplified Employee Pensions (SEPs)
8) 403(b) Plans
9) 457 Plans

It is possible that a defined contribution plan may contain the features of one or more of these types of plans, such as a Profit Sharing and 401(K) Plan. The differences between the types of defined contribution plans are listed below.

1. Profit Sharing Plans6:
   • The company makes discretionary, substantial and recurring contributions which may or may not be related to profits. Actual profits are not necessary.
   • The plan has a formula for dividing the employer contribution amongst the participants.
   • No employee contributions are permitted.
   • Loans and in-service distributions may be made (subject to the 10% additional tax if withdrawn before age 59½).
   • The contribution limit is the lesser of 25% of compensation or $49,000 in 2009 and 2010.

2. Stock Bonus Plans7:
   • Same features as in profit sharing plans as noted above except that contributions to the plan are in stock, rather than cash form.
   • Benefits from the plan may be distributed in the form of stock or in cash.
   • The participant has a right to take their distribution in cash.

3. Money Purchase Pension Plans8:
   • The employer contribution to this plan is required and is not discretionary.
   • The company’s contributions are based on a specific formula that generally incorporates the participant’s salary (e.g.: 2% of compensation).
   • Both employer and employees may contribute to the plan.
   • Loans may be permitted, but in-service distributions are not.
   • The contribution limit is the lesser of 25% of compensation or $49,000 in 2009 and 2010.

4. Employee Stock Ownership Plans (ESOPs)9.

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4 26 USCA §411(a)(2)(B).
5 More information on retirement plan criteria can be found at the Internal Revenue Service website at www.irs.gov or at the Department of Labor website at www.dol.gov.
6 26 USCA §401(a)(27); Treas. Reg. §1.401-1(b)(1)(i) and (ii)
7 26 USCA §401(a)(23)
8 Treas. Reg. §1.401-1(b)(1)(i)
• May be designed to look more like a profit sharing plan or a money purchase plan, however, the plan must primarily be invested in company stock.
• The participant can take their distribution in cash, just like a Stock Bonus Plan.

5. **Target Benefit Plans**:¹⁰
• This is a money purchase pension plan under which contributions to an employee’s account are determined by reference to the amounts necessary to fund the employee’s stated target benefit at retirement.
• The plan focuses on paying a certain benefit amount to the participant at retirement which is similar to the way a benefit under a defined benefit plan is expressed.
• The actual benefit paid is the account balance which will likely vary from the target benefit based on investment performance¹¹.
• Both employer and employees may contribute to the plan.
• Loans may be permitted, but in-service distributions are not.
• The contribution limit is the lesser of 25% of compensation or $49,000 in 2009 and 2010.

6. **401(k) Plans**:¹²
• This plan is a cash or deferred arrangement. The plan allows employees to elect to defer a specified portion of their salary as an employer contribution to the plan. The sums deferred under these plans are excluded from the employee’s taxable income.
• The employer also contributes to the plan per a formula (e.g.: match 50% of employee contributions up to X% of compensation).
• The employee is always 100% vested in own contributions. The employer contributions may be subject to a vesting schedule.
• Loans and in-service distributions are permitted (subject to the 10% additional tax if withdrawn before age 59½).
• The employee contribution limit is $16,500 for 2009 and 2010. An employee over 50 can make a “catch-up” contribution up to $5,500. The overall contribution limit between the employer and employee is the lesser of 25% of compensation or $49,000 in 2009 and 2010.

7. **Simplified Employee Pensions (SEPs)**:
• May be adopted by a business of any size, even a self-employed person.
• The SEP allows employers to make contributions on a tax-favored basis to individual retirement accounts (IRAs) owned by the employees subject to certain limits. An employee must set up the IRA to accept the employer contributions.
• A SEP is funded solely by employer contributions.
• The employee is always 100% vested in the money in the SEP-IRA.
• The overall contribution limit between the employer and employee is the lesser of 25% of compensation or $49,000 in 2009 and 2010. The Participant can withdraw contributions and earnings at any time (subject to the 10% additional tax if withdrawn before age 59½).

8. **403(b) Plans**:¹³
• Also known as a tax-sheltered annuity (TSA) plan, is a retirement plan for certain employees of public schools, employees of certain tax-exempt organizations, and certain ministers.

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¹⁰ Treas. Reg. §1.401-1(b)(1)(i)
¹² 26 USCA §401(k)
¹³ 26 USCA §403(b)
• Individual accounts in a 403(b) plan can be: 1) An annuity contract, which is a contract provided through an insurance company, 2) A custodial account, which is an account invested in mutual funds, or 3) A retirement income account set up for church employees.

• Just like in a 401(k) plan, a 403(b) plan allows the employee to defer salary to the plan.

• Loans and in-service distributions are permitted (subject to the 10% additional tax if withdrawn before age 59½).

• The employee contribution limit is $16,500 for 2009 and 2010. An employee over 50 can make a “catch-up” contribution up to $5,500. The overall contribution limit between the employer and employee is the lesser of 25% of compensation or $49,000 in 2009 and 2010.

9. **457(b) Plans**

   • Salary deferral plans set up by a state or local government or a tax-exempt organization under IRC 501(c).
   
   • These plans share many of the same features as 401(k) and 403(b) plans.
   
   • Loans may not be available.

Valuation of Defined Contribution Plans: All defined contribution plans have an individual account balance for the participant. If you have a defined contribution plan, the value of the plan is easy to determine. The value is the amount contributed to the plan plus any earnings growth or loss. The value of a defined contribution plans is the amount on the most recent statement.

Defined Benefit Plans: A defined benefit plan focuses on benefit or the sum the employee will be paid at retirement. A traditional defined benefit plan pays the employee a guaranteed payment each month in the form of an annuity until the employee dies. Many Union plans are defined benefit plans (but not all!).

Features of Defined Benefit Plans:

   a) The employee does not have an individual account.
   
   b) The employee cannot control the investment of their retirement funds.
   
   c) The employer assumes the investment risk.
   
   d) The accrued benefit is based upon a definite and pre-determined formula to calculate the ultimate benefit payable to the participant (e.g.: 2% of final highest pay x number of years employed (up to 30)).
   
   e) The contributions are mandatory and may not be contingent on profits.
   
   f) The plan must use the services of a actuary to calculate the appropriate employer contributions necessary to fund the plan’s benefit formula.
   
   g) The benefits are subject to the systemic payment of benefits rule, thus annuity forms must be available as a form of payment. Joint and life annuities must automatically be provided if the participant is married.
   
   h) Most plans do not permit loans.
   
   i) Vesting may be immediate or over a 7 year period (or shorter period).
   
   j) The plan may not pay a benefit more than $195,000 per year in 2010 (sum adjusted by inflation).
   
   k) The plan is covered by the Pension Benefit Guaranty Corporation (“PBGC”). If the plan is unable to pay the benefits [example: United Airlines bankruptcy], the PBGC will assume responsibility for paying some portion of the benefits due.

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14 26 USCA 457
15 26 USCA 401(a)(11)
16 26 USCA 411(a)(2)(A)
17 26 USCA 414(b)(1)
18 29 USCA 1301 et.seq.
A defined benefit plan requires an actuary to determine the amount of the employer’s contribution to the plan each year. The assumptions the actuary and employer must consider when funding such a plan are:

a) The employee participant’s current and projected compensation;
b) The mortality of the employee / participant and beneficiaries;
c) The amount of employee turnover / attrition;
d) The number of employees whom are married or for whom a form of a joint and survivor benefit may be paid;
e) The expected time of payment (early retirement, late retirement, etc.); and
f) The interest rate earned on the investments in the trust fund.

The Actuary then calculates a number based upon all the above factors and reduces it to a present cash value which is the plan’s annual contribution. This number is an educated estimate and can easily vary between two different actuaries depending upon the factors they use.

The risk of funding a defined benefit plan is the employer’s. The employee is guaranteed the benefit, the employer hopefully has calculated all above correctly to provide adequate funding for the plan to provide the benefit. However, due to increasing longevity and the tanking of the market, many plans are currently under-funded based upon the benefits they have promised to pay.

The following are several different types of defined benefit plans:

1) Fixed Benefit;  
2) Flat Benefit;  
3) Unit Benefit and  
4) Variable or Equity type  
5) Cash Balance Plan.

The only difference between the above types of defined benefit plans listed in 1-4 is in the benefit formula used. The Cash Balance Plan is structured differently than all of the other forms of defined benefit plans.

Cash Balance Plan

A Cash Balance Plan is a hybrid style plan. It is designed to look more like a defined contribution plan because it provides an employee with a hypothetical account balance rather than a benefit based on a formula which is generally paid monthly over life. The Cash Balance account is credited with: a) pay credit from salary and b) interest credit defined by the plan. The risk is completely on the employer to fund the account. Increases and decreases in value of the plan’s investments do not directly affect the participant’s benefit. The plan guarantees the benefit and interest credit. Most cash balance plans are conversions from traditional defined benefit plans.

19 Fixed Benefit – is a plan formula that provides a participant with a fixed percentage of compensation at retirement. The years of service are not part of the calculation, however, the plan may require a certain number of years of service to qualify for the benefit. If the plan pays 30% of compensation at retirement, the benefits provided would be the same whether a person works 10 years or 40 years.

20 Flat Benefit – is a plan formula that pays a specified amount at retirement regardless of salary or years of service. Such formula rewards neither seniority or compensation level.

21 Unit Benefit – is a plan formula that credits a participant with a certain unit of pension for each year of credited service. This formula may provide for a certain percentage of compensation times number of years.

22 Variable or Equity type – is any of the above formulas but once the formula is determined the benefit is adjusted periodically after retirement for the cost of living index.

23 26 USCA 401; 26 USCA 411; 29 USCA 1113; Revenue Ruling 2008-7, Public Law 109-280.
The Cash Balance Plan looks like a defined contribution plan because the participant has an account balance. However, like a defined benefit plan, the participant does not actually have a separate account within the plan; all funds to pay benefits are intermingled. The cash balance plan is like a defined benefit plan because the employer is the only one making contributions to the employees account. A defined contribution plan may allow the employee to contribute to their account. The Cash Balance Plan, like any other defined benefit plan does not allow the employee to control the investment of the funds. In a Cash Balance Plan, the employer controls the investment. A Cash Balance Plan is also covered by the PBGC, whereas a defined contribution plan is not.

**Valuation of Defined Benefit Plans:**

If you have a defined benefit plan, the value is a projected amount at retirement based upon the plan formula. A defined benefit plan may provide a benefit estimate. The defined benefit plan statement will provide that the benefit at age 65 (or another age) is X dollars a month. To determine a cash value from that estimate, you need an actuary to calculate the present cash value from the benefit that the plan estimates to pay at retirement.

**Other Retirement Plans:**

There are a number of other fairly common sources for retirement benefits and they are: 1) Supplemental Plans and 2) Government Plans. It is important to understand how these plans work as well before attempting to divide them in divorce.

**Supplemental Plans:** Many companies offer a supplemental pension programs for certain executives. These plans may be either defined contribution or defined benefit style plan and may be called a Supplemental Executive Retirement Plan (SERP), Top Hat Plans, Non-Qualified Plans or Surplus plans or other variations.

The purpose of these plans is to provide highly paid persons with retirement benefits above the IRS limitations. After all if you make a $1,000,000 a year, the maximum payout of $195,000 per year from the defined benefit plan at retirement would not begin to compensate for or replace your working income. Thus, for such executives, an employer may provide a supplemental plan.

The value of a supplemental plan depends on whether it is based on a defined contribution plan model or a defined benefit plan model.

What is important for a divorce practitioner to find out about a supplemental plan, in addition to the value of the plan, is whether or not the plan will accept a Qualified Domestic Relations Order (“QDRO”). Not all plans accept QDROs and if the plan does not accept a QDRO, then the overall property division strategy may need to be revised. The strategy may involve providing the non-participant with additional other assets (if there are any) to compensate for the value of the supplemental plan, or making the Participant the constructive trustee of a portion of the benefits comprising the Alternate Payee’s share of the supplemental plan if, as and when, such benefits are received by the Participant.

**Government Plans:** In addition to the private sector defined contribution and defined benefit plans, there are many government retirement plans that are divisible in divorce. Government pension systems are controlled by relevant statutory authority and not by ERISA. The statute will dictate the appropriate method of dividing the pension plan. Some examples of government pension plans are the:

- State Employees Retirement System of Illinois,
- Judges Retirement System,
- Municipal Employees Annuity and Benefit Fund of Chicago,
- Teachers Retirement System,
- Policeman’s Annuity Fund,

26 USCA 409A
Firefighters Pension Fund,
TIAA / CREF,
Military Retirement Plans,
Federal Employees Retirement System, and
Civil Service Employees Retirement System.

A government plan may provide benefits in a number of ways. If the plan is more like a defined contribution plan, then the value on the statement is accurate. However, many government plans are more like defined benefit plans. One of the differences is that the employee and the employer / government both contribute towards the benefits. The statement may provide a sum for the value of the employee’s contributions, and a final estimated monthly annuity amount for the benefit as well. The sums will be very different because both the government and the employee are contributing towards the final amount of the benefit. For example, a statement may show that the employee’s contributions are $150,000, but that the final benefit is $5000 a month for life. Based upon contributions alone, if paid $5000 a month, the employee would exhaust the retirement funds they paid into the system in 30 months. The plan pays $5000 a month for life, so the value of the benefit far exceeds the sums contributed by the employee. Be sure that you know what the benefit is that the participant will be paid. This type of plan may require an actuary to prepare an present cash value as well.

Plan Identification:

Since there are so many different types of retirement plans, how does one determine what type of plan the clients have? The most common method is to ask for copies of retirement plan statements or benefit estimates. It may or may not be obvious from the statement or benefit estimate what type of plan you have. If you can determine the information from the statement, you may not want to investigate further. If you cannot determine what type of plan you have from the statement, then hopefully the statement at least provides the Plan Administrator’s contact information. You can then contact the Plan Administrator and ask for the:

- Summary Plan Description
- Plan Document
- Model QDRO\(^\text{25}\) and
- QDRO (QILDRO) Procedures.

Usually a review of the Summary Plan Description will tell you what type of plan you are dealing with. If not, then the Plan Document may have to be reviewed to figure this out. The Model QDRO provided may also tell you what type of plan you are dealing with. If in doubt, contact the Plan Administrator and ask.

Once you know what type of plan you have, and have determined the value of the participant’s benefits, you can then proceed to divide the retirement benefits between the parties.

Plan Division:

Let’s look at a hypothetical negotiation about retirement benefits. The parties are both age 50 upon divorce. The wife has a Defined Contribution 401(k) Plan with a balance of $80,000. The husband has a Defined Benefit Plan with an accrued benefit of $80,000. All benefits are marital. It would appear their benefits are equal. If each keeps their own benefit, it would simplify the divorce because no additional paperwork would need to be prepared to divide the retirement benefits.

However, the husband’s benefit plan statement shows that the sum he currently has accrued will pay a benefit to him of $2000 a month at age 65 for the rest of his life. This calculates out to $24,000 a year.

\(^{25}\) QILDRO = Qualified Illinois Domestic Relations Orders which are used for many Illinois government plans.
He would receive a total of $80,000 in benefits over the course of 40 months (3 years & 4 months). If he lives 10 years, the value of his benefit is $240,000.

In the meantime, the $80,000 in the wife’s 401(k) account will increase or decrease depending upon market fluctuations. If she manages a compounded growth rate of 3% over 15 years, the total value of her account would be approximately $125,000 when she reaches age 65. Once the funds in the account are exhausted, that is it, her benefits run out.

Therefore, if each party keeps their own benefits, the husband would end up with a much larger benefit than the wife from benefits that appeared to be equal. If the goal is for each party to receive half of the retirement benefits earned at the divorce, that goal would not be reached by each party keeping their own benefits.

If the parties were to split the benefits 50/50, then the husband would receive $40,000 from the wife now (that he can put into an IRA) and in exchange the wife would receive the right to obtain $1000 a month for life at age 65. It would well be worth the investment of $40,000 now to obtain $120,000 over the course of 10 years in the future (or more if she lives longer). The parties would have to prepare Qualified Domestic Relations Orders (“QDRO”) to split the benefits and give their ex-spouse an interest in their respective plans.

Let’s vary the scenario a bit. The parties are still both age 50 upon divorce. Wife has the same Defined Contribution 401(k) Plan with a balance of $40,000. Husband has the same Defined Benefit Plan with an accrued benefit of $80,000. The Husband proposed providing $20,000 to the wife so that each has benefits worth $60,000. However, the Husband’s plan will not allow him to remove funds at this time. So instead, to equalize the retirement benefits, the Husband gives the wife an additional $20,000 from another asset.

The Husband’s plan is still worth the sum of $2000 a month to him at retirement. The wife will have $60,000 which again with a compounded growth rate of 3% over 15 years will be worth approximately $94,000. The equalization of benefits through an exchange of assets also would not provide the wife with a benefit equal to the husband’s.

The reason the result of a apparently equal benefit exchange is so different is because we are comparing apples to oranges. There are substantial differences between a defined contribution plan and a defined benefit plan. The accrued benefit in a defined benefit plan is not the value of the plan, whereas the value of the 401(k) plan is the statement balance26.

Therefore, before you agree to settle your case, be sure that you know exactly what the benefits you are dealing with are worth.

**Conclusion:** Be aware that defined contribution plans, defined benefit plans, supplemental plans and government plans all operate quite differently. In order to obtain an equitable settlement for your client, you need to understand what kind of plan you have and how to value it. Knowledge is power, so the more you know about the retirement plans that both parties have, the better prepared you are to discuss an appropriate settlement or be ready for trial.

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