Pension Evaluations - Tax Consequences - Equitable Distribution Federal Retirement Systems

PENSION EVALUATION - PRESENT CASH VALUE IMMEDIATE OFFSET SETTLEMENTS TAX CONSEQUENCES – EQUITABLE DISTRIBUTION

The purpose of an Immediate Offset Settlement is to allow the plan participant (hereinafter referenced as "employee spouse") to retain his or her full pension while transferring to the non-employee spouse an asset of equivalent value. For example;

Tom Smith a Law Enforcement Officer and his spouse Mary Smith are divorcing. Tom's pension is a typical Law Enforcement Officer's Benefit. For purists: note that I have rounded values for an easier to follow presentation.

Two marital assets exist.
A home worth: $470,000.00
Tom's pension worth: $470,000.00*
*This recognized annual post-retirement COLA increases of 2.5%

The parties agree that Mary will surrender her interest in Tom's pension ($235,000.00) in exchange for Tom's interest in the marital home. At the end of this settlement each spouse has an asset worth $470,000.00 (Tom the full worth of his pension and Mary the full worth of the home). Does this format (clearly oversimplified) represent an "equitable distribution" of marital assets?

To determine if this settlement constitutes an "equitable distribution" of marital assets, it is necessary to develop in greater detail the generally overlooked or unanticipated Federal Income Tax consequences of the Immediate Offset settlement.

Essential Consideration:

Does the traditional Immediate Offset settlement recognize the federal income tax consequences that will impact on the pension spouse (the employee)?

Relevance of Internal Revenue Code Section 1041(a)(2).

No gain or loss shall be recognized on a transfer of property from an individual to…
(2) a former spouse, but only if the transfer is incident to the divorce.

Thus, the transfer to the Wife of Tom's interest in the home, worth $235,000.00 is a "tax free transfer". This waiver of Mary's pension rights (in Tom's pension) to the extent of $235,000.00 in exchange for $235,000.00 of real estate (Tom’s interest in Home) is without federal income tax consequences.

This leads to the obvious query: Will Tom receive equally advantageous tax treatment on the portion of the pension plan that was waived by Mary? To make this decision it is necessary to determine what will be the tax treatment of Mary’s waived interest in Tom’s pension plan ($235,000.00) when received by Tom?

Mary received $235,000.00 without a federal income tax consequence. Thus, it is unquestioned that Mary has received the unreduced sum of $235,000.00. Can Tom expect the same special tax treatment for that portion of his pension plan that was waived by Mary? No! Tom’s entire pension will be fully subject to federal income taxes (less employee contributions, See 26 U.S.C 72(b)(1)[Exclusion Ratio].

Immediate Offset Pension Evaluations. Expressing Present Cash Value of the Marital Part of a Pension. Recognition of Federal Income Tax Consequences. This Offset can’t be accomplished in an equitable format unless there is Recognition of the Federal Income Tax Consequences that result from pension distributions to the retiree. See “deemed distributee”, 26 U.S.C. 402(a).

In the division of marital assets, Troyan stated above:

As a result of this settlement each spouse had an asset worth $470,000.00.

Now, I wish to argue that the above statement is misleading. Why? Because it failed to recognize the fact that while Mary received full value Tom did not.

Commentary:

Only one transfer actually took place at the time of divorce. A tax free property transfer to Mary. Tom’s asset, his pension remains in an employer trust and will be distributed to Tom as an annuity over his lifetime. Will these distributions from the pension plan to Tom provide him with the same tax free advantages afforded to Mary? No! The following calculations will show that in Immediate Offset Settlements the failure to properly reduce the worth of the pension by tax consequences produces an inequitable distribution.

A Simple Federal Income Tax Consequence Procedure.
Step I.

Convert the pre-tax present cash value as represented in a traditional Immediate Offset Pension Evaluation to its actuarially equivalent annual benefit.
Marital Annual Benefit At time of Divorce: $24,000.00
To Mary: $12,000.00

Clarification:
At the time of settlement, Mary did not get an annual benefit of $12,000.00. Instead she received the actuarial equivalent (present cash value) of this annual benefit. ($235,000.00) in the form of a non-taxable transfer of real property.

Step II.
Retirement Age Assumption.
Tom retires age 50 (not unusual for a Policeman)
His life expectancy at age 50 is: 32 years

Step III.
Tax Bracket Assumption.
Assume a reasonable federal income tax bracket based on the current tax table. For this illustration I have assumed: 22%

Step IV.
Interest Assumption.
There is no single interest assumption that will fit all situations. To compute present cash value for Qualified Defined Benefit Plans the Pension Protection Act added 26 USC 430(h)(2)(C), which created "Segment Rates". In this article I have used the applicable "segment rate", based on the rates for January 2011: 3.14%

Step V.
Based on the above assumptions compute the Immediate Annuity Cost of the "stream of annual federal income tax consequences".

Annual Tax Consequence:
$12,000.00 * 22% = $2,640.00

Tom's Life Expectancy (at retirement): 32 years
Interest Assumption: 3.14%

The resulting present cash value of the
Tax stream that equates to Mary's waiver
of Tom's pension benefits: $35,000.00

Adjusted Pension present cash value reflecting
Tax Consequences of Tom's Distribution: $435,000.00
($470,000.00 - $35,000.00)

Based on Tax Adjusted Amount, the present cash
value of half of the marital benefit: $217,500.00
$435,000.00 ÷ ½

Reduction in Award to Mary if Tax Consequence
Is recognized: $17,500.00

In the above discussion the overstatement in present cash value of Mary's award was 8.09% or $17,500.00. The probable cost of inclusion of the actuarial present cash value of the stream of tax consequences should be approximately $200.00. Hence, is this illustration an added cost of $200.00 would have saved the employee spouse $17,500.00. In cases involving more substantial benefits the absolute amount of this overstatement of the employee spouse's benefit is likely to be significantly greater. What is probable is that failure to recognize the federal income tax consequences of a "Traditional Pension Evaluation" that impacts on the employee spouse will result in an overstatement of the intrinsic worth of the pension's present cash value as it relates to the employee spouse. Troyaninc, is able to prepare Immediate Offset Pension Evaluations that calculate the Federal Income Tax Consequences to the employee spouse/retiree and the resulting reduction of the present cash value of the marital component of the pension plan.

Commentary:
It is emphasized that this Practice Aid does not necessarily represent the views of the Troyan Rather, it is presented for information and educational purposes only.