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Pension Plans, Nonemployee Spouses and Taxation Problems

FAMILY LAW: Lawyers should consider tax consequences when benefits are divided between spouses.

Upon divorce, a nonemployee-spouse may be entitled to receive a portion of the employee-spouse's retirement pension benefits either immediately or at a later date. With certain pension plans, however, the nonemployee-spouse cannot receive payments directly from the plan but instead must receive them from the other spouse.

This situation arises frequently when one spouse is eligible to retire and receive a pension but wants to keep working. In this situation, many courts will allow the nonemployee-spouse to receive his or her share of the pension before the employee-spouse retires.

When the nonemployee-spouse receives his or her share of the pension from the employee-spouse and not directly from the pension, liability for taxes on the pension benefits becomes an issue. If the nonemployee-spouse can receive the share directly from the pension plan, through a qualified domestic relations order, or QDRO, then the nonemployee-spouse assumes the tax liability for the amounts received. I.R.C. Section 402(e)(1)(A).

If a court cannot order the pension to directly pay the nonemployee-spouse, however, then it appears that, upon eventual receipt of the pension funds, the employee-spouse assumes tax liability for the entire amount received.

Moreover, amounts the employee-spouse transfers to the nonemployee-spouse pursuant to a buyout of the nonemployee-spouse's interest in the pension are not taxed. *Balding v. Commissioner*, 98 T.C. 368 (1992). In other words, the nonemployee-spouse may receive his or her share of the pension tax-free, while the employee-spouse is liable for the *entire tax* resulting from the eventual pension distribution.

The leading case of *In re Marriage of Gillmore*, 29 Cal.3d 418 (1981), established what has become known as the "Gillmore election." Subject to certain restrictions, this election allows the nonemployee-spouse to receive his or her share of the retirement plan before the employee-spouse retires. If the plan cannot be ordered to make payments directly to the nonemployee-spouse, then the right to receive immediate payment from the employee-spouse is subject to whether sufficient assets or income exist for a "buyout."

California Civil Code Section 4800.8 empowers the court to order a private or government retirement plan to make direct payments to a nonemployee-spouse before the employee-spouse retires if the plan's contract (or the Public Employment Retirement Plans, State Teachers Retirement System or Judges Retirement Law regulations, if applicable) allow such payments. *In re Marriage of Nice*, 230 Cal.App.3d 444 (1991); *In re Marriage of Jensen*, 235 Cal.App.3d 1137 (1991) (following *Nice*) (in the absence of a specific provision in the plan, a public pension plan may not be required to disburse vested and matured community property retirement funds to a nonemployee-spouse before the employee-spouse actually retires).

Assuming that the employee-spouse pays the nonemployee-spouse his or her share of the pension, requiring the nonemployee-spouse to pay taxes on the funds received becomes problematic. With respect to the tax liability when the employee-spouse eventually receives the pension, the tax court in *Darby v. Commissioner*, 97 T.C. 51 (1991), appears to hold that retirement funds received by the employee-spouse are taxable to the employee-spouse, even though half of the funds were transferred to the former spouse pursuant to a divorce decree.

Not surprisingly, employee-spouses argue that the spouses should share future tax liability equally. Of course, this tax issue arises only when the pension plan does not make direct payments to the nonemployee-spouse.

As a general rule, only tax consequences that are "immediate and specific" may be considered in dividing marital assets. *In re Marriage of Bergman*, 168 Cal.App.3d 742 (1985), held that the tax consequences of nonmatured benefits to be received 17 years after separation are not "immediate and specific" and hence cannot be considered in dividing the pension.

One non-California case dealt with these tax issues in an interesting manner. In *In re Marriage of Blake*, 807 P.2d 1211 (1990), the court issued what it called a "relatively innovative order." The employee-spouse was ordered to pay the nonemployee-spouse her share of the pension in monthly payments that were to continue until her death, regardless of whether she remarried. These monthly payments were characterized as "maintenance in gross" and were deductible as taxable alimony.

Attorneys representing an employee-spouse should consider ways to include the effect of taxes on valuing and dividing retirement benefits. If the relevant jurisdiction does not allow these considerations, or if the time until retirement is far away, creative planning may be required.

One method is to award the nonemployee-spouse an equivalent amount of assets subject to expected future taxation. Another option would be to make payments from the employee-spouse to the nonemployee-spouse qualify as taxable-deductible alimony. Of course, the various federal requirements must be met. In any case, attorneys representing the employee-spouse must contend with the "immediate and specific" tax rule.

Retirement benefits are often among the largest marital assets — if not the largest. Thus, it behooves those dividing marital assets to consider the tax consequences of dividing retirement benefits.

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