When is a 401k Not a Retirement Account?

The equitable distribution statute contains specific requirements for the classification and distribution of "pension, retirement or other deferred compensation benefits." GS 50-20.1. Because these retirement accounts frequently are the most valuable asset in an equitable distribution case, it is significant that the court of appeals held in *Watkins v. Watkins*, 746 S.E.2d 394 (N.C. App. 2013), that a 401K, one of the most common retirement accounts today, generally is not "deferred compensation" and therefore does not fall within the restrictions of GS 50-20.1.

The Coverture Fraction

A court has limited options for distributing any form of retirement, pension and other form of deferred compensation benefits in equitable distribution, and classification is determined by application of the **'coverture fraction'** found in G.S. 50-20.1(d):

"The award shall be determined using the proportion of time the marriage existed (up to the date of separation of the parties), simultaneously with the employment which earned the vested and nonvested pension, retirement, or other deferred compensation benefits, to the total amount of time of employment."

This fraction conclusively determines the extent to which a deferred compensation plan is marital property. If a spouse started working at the job which earned her deferred compensation during the marriage, the value of the account on the date of separation will be entirely marital. If however, the spouse started working 5 years before marriage and continued working during the marriage for 5 more years until the date of separation, 5/10's or ½ of the date of separation value of the account will be marital.

Two Types of Retirement Accounts

There are two types of deferred compensation accounts; one is a **defined benefit account**, which is a traditional pension. An employee is paid upon retirement an amount determined by things like years of service and salary level. The employee does not accumulate an identifiable fund of money but instead will be paid from a common fund and will be paid for life.

The second type is a **defined contribution account,** a fund containing a specific amount of money that belongs to a specific individual. The amount paid during retirement is determined entirely by the amount of money in the account. A 401K is one example of a defined contribution plan.

The Coverture Fraction Applies to Both

Robertson v. Robertson, 167 N.C. App. 567 (2004), held that the coverture fraction must be used to classify both types of deferred compensation accounts due to the restrictions in GS 50-20.1.

But is That Fair?

The coverture fraction is considered by most to be a good enough method of classifying a **defined benefit plan**. It is a simple formula that treats all years of employment as contributing equally to the value of the plan and there is no obvious way to more accurately determine how much of the benefit was acquired during the marriage.

However, because a **defined contribution plan** is a specific fund to which contributions are made over time, it is possible to show that some contributions to the account make up a larger portion of the value on the date of separation due to the accumulation of interest or because more money was contributed in some years than in others. In other words, it is possible to prove that treating all years of contribution equally, as does the coverture fraction, results in an inaccurate classification.

Watkins

Watkins is the first published opinion directly addressing a 401k plan. Acknowledging GS 50-20.1 requires that all deferred compensation plans be classified using the coverture fraction, the court held 'deferred compensation' has a different meaning in the context of equitable distribution than it has for the IRS. According to *Watkins*, a fund or account is not ***deferred*** compensation if the owner has access to the funds in the account on the date of separation. If it is not deferred compensation, it is not subject to the restrictions in GS 50-20.1.

The court explained that application of the coverture fraction to all defined contribution plans:

…"would lead to grossly inequitable results where, for example, significant amounts of property earned during the marriage could be treated as separate property, as the value of these accounts is largely, if not entirely, determined by contributions from the owner and *not* on the number of years of service to a particular company. For example, suppose that an individual opens an IRA and contributes a total of $6,000.00 to the account over a nine-year period. Assume that after these nine years the individual marries, and, because the spouse is a wage-earner, the individual is able to contribute $42,000.00 to the account during three years of marriage. If the parties separate after these three years and the trial court is required to apply the coverture ratio to the IRA, then only $12,000.00—or 25 percent of the $48,000.00 balance—would be considered marital property—since the individual was married only 25 percent of the time he funded the account, even though $42,000.00 of the account was funded by the individual's earnings during the marriage."

Watkins, 746 S.E.2d at 398-99.

A 401K May Be Partially Retirement

Watkins further explains that an account may contain ***both*** deferred compensation and funds that are not deferred:

The employee contributions, which can be withdrawn by the employee at any time, clearly do not represent a "deferred compensation benefit…. Similarly, 401(k) plans which provide for immediate vesting of employer contributions do not provide "deferred compensation benefits," as there is no deferral of benefits under such plans. [However], employer contributions [that] vest over a designated period of time … might be construed as "deferred compensation benefits;"….

Watkins, 746 S.E.2d at 398.

So what does this mean?

The court must determine whether the account to be classified is all or partially a retirement, pension or other deferred compensation plan to know whether the classification and distribution restrictions found in GS 50-20.1 apply or not. For more analysis, see Family Law Bulletin #26.