

LOSAPs & Divorce

A Length of Service Award Program (LOSAP) is often referred to as a pension. Although a LOSAP is similar to an IRS qualified pension plan in that it provides a sponsor-paid benefit at retirement or entitlement age, it is NOT a qualified plan, nor is it a non-qualified deferred compensation plan. In fact, it is not a pension plan at all, under the Internal Revenue Code. It is probably most accurately described as a plan of deferred payment.

For this reason, and others described in this article, a LOSAP cannot recognize an assignment to a former spouse under a Qualified Domestic Relations Order (QDRO), like a private tax-qualified retirement plan does, or the similar Domestic Relations Order (DRO), that applies to governmental plans, such as the New York State Retirement System.

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When a volunteer is going through the divorce process, the volunteer's LOSAP, like the volunteer's tax-qualified retirement plan, is generally considered a marital asset. After the divorce, the parties may request that the court issue a DRO/QDRO in order to assign a portion of the qualified retirement plan earned during the marriage to the ex-spouse. Sometimes, the parties also ask the court to issue a DRO/QDRO for the LOSAP. Unfortunately, there are times when Penflex receives a completed and signed DRO/QDRO that *do not* apply to LOSAP. We must then inform the parties involved that the order is not acceptable. We hope that this article will help attorneys and/or volunteers and their ex-spouses understand why this is true, and take the alternative steps proposed to avoid this result.

In many cases, state-specific law requires the government sponsor of a LOSAP to fund the LOSAP through contributions into a trust fund. In order to prevent the LOSAP benefit from being includible in the income of the volunteer before it is eligible for payment, the type of trust utilized is a grantor trust (also referred to as a rabbi trust). With this type of trust, assets reserved to pay LOSAP benefits remain assets of the sponsor and do not belong to the LOSAP participants until payment is due. As a requirement of the trust, the assets are subject to the creditors of the sponsor. As participants become eligible for benefits, the payments become taxable to the participants as they are paid or made available to the participants. To preserve this tax treatment, the grantor trust must contain the language issued by the IRS in Revenue Procedure 92-64, which states: "Benefits payable to Plan participants and their beneficiaries under this Trust Agreement may not be anticipated, assigned (either at law or in equity), alienated, pledged, encumbered or subjected to attachment, garnishment, levy, execution or other legal or equitable process."

We were advised by our legal counsel that violating this non-assignment language in the grantor trust by permitting the assignment of a LOSAP benefit, as evidenced by a court order, would most likely cause the trust to fail as a grantor trust. Such failure would result in the trust beneficiaries (i.e., the LOSAP participants) realizing income equal to their accrued benefit under the trust. This means that every participant would have to pay taxes on the benefits as they are accrued and not just when they are paid. Clearly, this is not a desirable outcome.

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Even when a trust is not required by state law, if a LOSAP sponsor is reserving assets to pay for the promised benefits (versus a pay-as-you-go approach), the program documents should state that these assets are part of the general assets of the sponsor and are subject to the sponsor's creditors. With this approach, the assets simply are not held in trust and theoretically could be used for other purposes. Similar to the trust approach, this structure would prevent a participating volunteer from having to pay income tax on their vested accrued benefits before they are paid. Since the LOSAP assets are the sponsor's, allowing a volunteer to assign benefits/assets that they do not *own* to an ex-spouse would not be appropriate. As such, we believe the program documents should include similar non-assignment language as provided for in the grantor trust, thereby making a DRO/QDRO not applicable either.

Since a significant number of our clients are in New York State, we must address the fact that New York State General Municipal Law (GML), Article 11-A, §217(l), states that "No service award provided under the program may be assigned or alienated except to provide for the legally obligated support of minor children or spouse." Even if it could be successfully argued that the assignment of a service award to an ex-spouse could be considered "legally obligated support," we were again advised by legal counsel that due to the language in the trust, such assignment should not be permitted. This is not the first time, and likely not the last, that New York State law conflicts with federal law (e.g., the age discrimination issues regarding post-entitlement age accruals, \$3,000 federal cap on accruals, and so on.)

The LOSAP benefit earned during marriage is typically considered a marital asset, but a portion of it cannot be assigned to an ex-spouse. We suggest that the value of the LOSAP be considered when dividing other marital assets. An agreement could be reached whereby the volunteer must pay a portion of the lump-sum value of the LOSAP benefit to the ex-spouse or "traded off" when splitting other marital assets (i.e., the volunteer keeps the LOSAP and the ex-spouse keeps another marital asset of equal value). Another option would be to require that the participant pay the ex-spouse a portion of the benefit received at entitlement age directly and thus, not directly from the LOSAP assets. Whatever arrangement is agreed upon, all parties should be mindful of the tax implications, as the participant will be responsible for paying taxes on the full amount distributed from the program. As such, an adjustment may be necessary to reflect these tax considerations.

To reiterate and summarize, we have been advised that LOSAP sponsors should not permit the assignment of any portion of a LOSAP benefit to a third party and the equitable distribution of an accrued LOSAP benefit should be worked out by the parties outside the LOSAP.

Penflex, Inc. provides actuarial, administrative and consulting services for roughly 400 LOSAPs. Penflex does not provide legal advice and we suggest that each LOSAP sponsor seek advice of a qualified attorney on this matter. The information provided in this article is based on our experience and consultation with our own legal advisors.

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