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# Dividing pensions on marital dissolution

This is Ms. DiFranza's first major article. Much has changed since then including the passage of the Retirement Equity Act of 1985 and California's Family Code Section 2610.

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**I**N most marriages, the family home and the spouses' pension rights are by far the most valuable community property assets. When a marriage dissolves, the spouses' attorneys must assure that those assets are properly divided between husband and wife. The problems of dividing the family home are relatively well known and well handled by most family lawyers. The difficulties of splitting pension rights are not. Yet pension plans are not so arcane as many family lawyers believe. An understanding of the concepts discussed in this article should enable the family lawyer to avoid the common pitfalls in dividing pensions on marital dissolution.

When a marriage dissolves, the spouses' pension rights are usually divided either by the present cash value method or by the reserved jurisdiction method.<sup>1</sup> Under the present cash value method, the community property portion of a spouse's pension is determined, valued and assigned to the employee spouse. To keep the division of community property even, an equivalent value of other community property is assigned to the other spouse.<sup>2</sup>

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<sup>1</sup>Sometimes, pension rights, particularly those in a defined contribution plan (see 29 U.S.C. § 1002(34)), are divided by other means, such as by terminating the pension, dividing the pension in two or obtaining loans against the value of the pension. (See Hardie & Reisman, *Employee Benefit Plans and Divorce: Type of Plan, Date of Retirement, and Income Tax Consequences as Factors in Dispositions* (1978) 5 Community Prop. J. 179.)

<sup>2</sup>If other community property is insufficient to counterbalance the pension's value, the

Under the reserved jurisdiction method, pension rights are determined on dissolution, but no money or other assets change hands until a spouse actually receives or is eligible to receive pension payments. At that later time, the actual or imputed (see *In re Marriage of Luciano* (1980) 104 Cal.App.3d 956, 960) pension payments are divided between the spouses in accordance with their community property interests in the pension.

In order to advise a client properly, a family lawyer must understand the advantages and difficulties of both these methods, be able to advise the client about each of them, and be able to use either of them depending on the client's needs.

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## The present cash value method

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The key to the present cash value method of dividing pension rights is obtaining a proper appraisal of the value of the pension. To perform this task, the lawyer should engage an actuary. Finding a competent actuary is the attorney's first task.

Unfortunately, there are only six schools in the entire country which offer degrees in actuarial science. Most actuaries learn their craft through self-study. California does

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spouse receiving the pension can "buy out" the excess value with separate property funds, such as a loan obtained after separation. However, such a "buyout" may cause adverse income tax treatment of the transaction.

not examine or license actuaries. Hence, neither degrees nor state licenses ease the lawyer's job in selecting a competent actuary. Instead, an attorney must rely on the actuary's membership in various professional groups.

Actuaries may become members of the **Society of Actuaries** only by passing the society's rigorous examination. Membership in this society is a hallmark of actuarial competence. The **Conference of Actuaries** used to allow membership based on actuarial experience; now new members must pass the Society of Actuaries' examination as well. Although originally formed to include only the most qualified actuaries, the **American Academy of Actuaries** now allows all enrolled actuaries to become members. In order to certify valuation results in ERISA pension plans, an actuary must be enrolled with the Departments of Treasury and Labor. Though some actuaries were grandfathered in, all actuaries now seeking enrollment must fulfill certain experience requirements and pass an examination, which however is less rigorous than the Society of Actuaries' test. The **American Society of Pension Actuaries** was formed by consultants to small pension plans in order to serve needs generated by ERISA. Only recently has this society adopted an examination requirement and otherwise raised its membership standards.

In addition to membership in an appropriate professional group, the actuary should be familiar with California case law on division of pension rights and should have experi-

ence in appraising such rights in the marital dissolution context. Before engaging an actuary, the family lawyer should inquire about his experience in these areas.

After finding a competent actuary, the lawyer's next step is to provide the actuary with the information he will need to appraise the pension rights. Most actuaries will provide a form requesting the information they need.

The requested information normally includes the dates of birth of the employee and his spouse, the dates of their marriage and separation, the employee's sex, date of employment and monthly salary. If the employed spouse has retired, the date of retirement and the amount of the monthly pension payments he receives should also be stated. The actuary will also need copies of the most recent employee benefit statement, any pertinent correspondence, salary history data and the plan or a description of its benefit provisions. The actuary should also be told if either spouse's health is impaired for any reason.

To secure the needed information, the family lawyer should request the employer or union to provide any information and documents which the client does not have. Cooperation between counsel for the spouses should make it easier and less expensive to get this information. If cooperation is not forthcoming, Civil Code section 4363.1 offers alternate means to the same end. Cooperation in hiring a single actuary to perform the appraisal for both spouses can also achieve important economies.

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### Actuarial appraisal

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With the requisite information in hand, the actuary must estimate the present value of the right to receive a future stream of pension payments under the plan. In making this estimate, the actuary must pay particular attention to longevity, interest, vesting and continued employment.

Under most pension plans, benefits cease when the employee dies. Consequently, in determining how much an employee will eventually receive under a pension plan, the

actuary must take the employee's longevity into account. To do so, most actuaries use the actuarial method<sup>3</sup> which assigns progressively lower values to payments to be received in later years in order to reflect the increasing probability that the employee will die before the payment is made.<sup>4</sup>

If the employee suffers an illness or disability which tends to shorten his or her life significantly, the actuary may decide to apply alternate life expectancy tables in discounting the value of future pension payments. Otherwise, the actuary can prepare a cash flow analysis from which the court can value the pension rights once it has determined how significantly the illness or disability affects the employee's life expectancy.

The actuary must also discount

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<sup>3</sup>The life expectancy method, based on selecting a hypothetical date when the employee will most likely die, is easier to understand than the actuarial method, but its use has been widely condemned by actuaries and courts. (See *Wetherbee v. Elgin, J. & E. Ry. Co.* (7th Cir. 1951) 191 F.2d 302, 311.)

<sup>4</sup>The probability of the employee's dying by any given date is derived from mortality tables. If offered to show life expectancy, such tables are controlling unless other evidence shows an expectancy greater or less than the tables indicate. (See *Emery v. Southern Cal. Gas Co.* (1946) 72 Cal.App.2d 821, 824-826.) The actuary should choose a mortality table which matches the person whose pension is being appraised.

the value of future pension payments to reflect the fact that they are not received now, but only in the future. Currently, many actuaries use a 7 percent per annum discount, of which 5 percent represents the rate of inflation and 2 percent represents the pure interest rate—that is, the cost of borrowing money in a noninflationary world.

For the employee a higher discount rate is advantageous because its use results in a lower pension value; hence, in a lower community property value for which he must compensate the nonemployee spouse. Though interest rates and inflation are each well over 7 percent at present, most actuaries are reluctant to increase the discount rate for two reasons. First, until recent years, rates of interest and inflation were far lower than they now are. For example, from 1948 to 1967, inflation averaged less than 2 percent per year. In predicting future rates of interest and inflation, actuaries rely heavily on these historically lower rates. Second, if inflation continues at its present high rate, pension plan sponsors will probably be forced (by social pressures if not otherwise) to increase pensions on an *ad hoc* basis to compensate for the decreased buying power of the pensions previously set in the plan. Such increases will, of course, partially or fully offset the effect of a high rate of inflation.



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Many pension plans set benefits at a percentage of the average salary the employee received during the last three or five years of his employment. Since salaries are likely to increase with inflation, an employee can offset the effect of inflation in such plans simply by continuing to work longer. Under such a plan, until retirement an employee's pension rights diminish in value not by the full discount rate (including inflation), but only by the amount by which the discount rate exceeds the rate of increase in the employee's salary.

After retirement, salary adjustments will no longer offset inflation. Unless the pension plan calls for cost-of-living adjustments in benefits or the employer increases pensions on an *ad hoc* basis, the pension will feel the full effect of the combined discount rate. Fortunately, many pension plans, particularly for public employees, do provide for cost-of-living increases. Federal civil service plans are fully indexed to cost-of-living increases, while state plans allow inflation adjustments only up to 2 percent per year. With such plans, a lower discount rate is appropriate to reflect the plan's compensation for inflation.

If the employee has not yet worked long enough to acquire vested pension rights—that is, rights which will not be forfeited if employment is immediately terminated—the actuary must also discount the unvested pension rights to account for the chance that the employee will quit or be fired before the pension vests. Though the Supreme Court has stated that unvested pension rights are community property which must be divided (*In re Marriage of Brown* (1976) 15 Cal.3d 838, 848), it has left the valuation and division of such pension rights to the trial courts' discretion. No later case had indicated how unvested pension rights are to be valued.

Absent judicial guidance, a reasonable method of accounting for the chance that employment will end before the pension vests is to reduce the value of unvested pension rights by the percentage of additional required employment. For example, if the pension vests after five years of employment and at trial the employee has worked only four years, he still has 20 percent of

the required employment period to go. Such a discount recognizes that the longer the employee has been on the job the more likely it is that he will continue in employment to the vesting date.

Finally, the actuary must take into account the likelihood that the employee will continue in employment from the vesting date until the earliest retirement eligibility date. As already explained, most pension plans set pension benefits at a percentage of the average salary over the employee's last three or five years of employment. The longer the employee continues in employment the higher his ending salary is likely to be; hence, the higher his benefits will be. Even though the higher salary is earned after dissolution of the marriage, under the "time rule" repeatedly used by the California courts,<sup>5</sup> the community portion of the pension rights receives part of the increase in value attributable to the later higher salary. In essence, the employee is treated as if he earned the same amount of pension rights each month of his employment even though in earlier months his salary was lower.

To account for this effect, the actuary could assume that the employee would quit immediately (accrued benefit method), or the actuary could assume the employee will continue in employment until the earliest date he is eligible to retire (projected benefit method). These two methods represent extremes, however. A more reasonable approach is to take a weighted average of those methods, again assuming that the longer an employee works, the more likely it is that he will continue in employment. For example, if under the projected benefit method, an employee's pension is worth \$100,000, while under the accrued benefit method it is worth only \$70,000, the difference—the value added by continued employment—is \$30,000. If it is also assumed that the employee has al-

<sup>5</sup>*In re Marriage of Judd* (1977) 68 Cal.App.3d 515, 522; *In re Marriage of Adams* (1976) 64 Cal.App.3d 181, 186; *In re Marriage of Anderson* (1976) 64 Cal.App.3d 36, 39. A variation on the time rule—apportionment on the basis of points earned toward a National Guard pension—was allowed in *In re Marriage of Poppe* (1979) 97 Cal.App.3d 1, 11.

ready worked 20 years, but has 10 more years to go before retirement, one can figure the probability of continued employment until retirement as the number of years already worked (20) divided by the total period of employment until retirement (10 + 20 = 30). The actuary can then multiply this probability fraction ( $\frac{2}{3}$ ) by the added value of continued employment (\$30,000) and add the result (\$20,000) to the accrued benefit method figure (\$70,000) to arrive at a more realistic present value of the pension rights (\$90,000).

As yet, there is no judicial authority to support the methods given above for discounting pension rights based on the likelihood that the employee will continue to work through vesting and to retirement. But the proposed formulas are more logical than those recently approved for valuation of the goodwill of businesses and professional practices.<sup>6</sup> Use of the suggested discount methods should fall within the trial court's broad discretion absent persuasive evidence that there is a higher or lower probability of continued employment.

Though pension payments will surely be taxed, the actuary cannot discount the pension's value by taking such taxes into account. Courts have refused to allow a discount for taxes because they find estimation of future rates of taxation too speculative.<sup>7</sup>

Income taxes may pose a different problem to the present cash value method of dividing pension rights, though. Some tax attorneys and family lawyers have argued that allocation of all pension rights to the employee spouse may be considered an assignment of income, making the nonemployee spouse liable for taxes on pensions paid the employee spouse. (1979 American Fam-

ily Law Tax Rptr. 1098.) To surmount this problem, the nonemployee spouse's attorney might recommend that the court reserve jurisdiction over tax consequences<sup>8</sup> or might allow a reasonable discount for projected tax liabilities. If a discount is given, the nonemployee spouse should insist on an agreement that the employee spouse pay any tax liability resulting to either spouse from the employee spouse's receipt of the pension.

### The reserved jurisdiction method

Under the reserved jurisdiction method of dividing pension rights on marital dissolution, only the formula for division is settled at the time of divorce. The actual division is delayed until pension payments are received. For this reason, the reserved jurisdiction method is the most frequently used and abused method of dividing pension rights. Unless counsel are aware of, and take steps to avert, the potential future problems associated with it, the reserved jurisdiction method can produce very unfair results.

If the reserved jurisdiction method is used, counsel should first join the pension plan as a party to the dissolution proceeding.<sup>9</sup> Under rules 1291.15 through 1291.40 of the California Rules of Court, a pension plan may be joined by a simple *ex parte* application to the court clerk.

Joinder is necessary to insure compliance with the prospective division of pension payments. (See Civ. Code, § 4351.) If the plan is not joined, the court cannot order it to split pension payments between the former spouses or otherwise assure that the nonemployee spouse receives his due when, many years later, pension payments begin. Also, a joined pension plan can help frame the judgment so that it can

<sup>6</sup>See, e.g., *In re Marriage of Barnert* (1978) 85 Cal.App.3d 413; *Geffen v. Moss* (1975) 53 Cal.App.3d 215, 225 & fn. 2; *In re Marriage of Foster* (1974) 42 Cal.App.3d 577. See also *Lurvey, Professional Goodwill on Marital Dissolution: Is It Property or Another Name for Alimony?* (1977) 52 State B.J. 27 and *Norton, Professional Goodwill—Its Value in California Marital Dissolution Cases* (1976) 3 Community Prop. J. 9.

<sup>7</sup>*In re Marriage of Fonstein* (1976) 17 Cal.3d 738; *In re Marriage of Marx* (1979) 97 Cal.App.3d 552, 560.

<sup>8</sup>But see *In re Marriage of Clark* (1978) 80 Cal.App.3d 417, 424, fn. 5 discouraging reservation of jurisdiction.

<sup>9</sup>It may be advisable to join a pension plan even when the present cash value method will be used. A joined pension plan is subject to normal discovery; interrogatories and requests for production can quickly secure the information needed for an actuarial appraisal of the pension rights.

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most easily be followed by the plan and the spouses.

The only disadvantage to joinder is the remote possibility that the plan will object, arguing that ERISA has preempted state law or that division of pension rights violates the plan's provision prohibiting assignment of benefits. The plan might also try to remove the proceeding to federal court. All of these maneuvers are doomed. (*In re Marriage of Pilatti* (1979) 96 Cal.App.3d 63, 66; *Johns v. Retirement Fund Trust* (1978) 85 Cal.App.3d 511, 513.) But fending them off can be expensive.

Fortunately, most plans have abandoned such tactics and now cooperate with counsel, sometimes even providing sample clauses for counsel's consideration. To take advantage of such cooperation, counsel should send the pertinent portions of any proposed judgment or settlement to the plan before trial or settlement so that the plan can comment on them or even join in them by a three-way stipulation.

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#### How the reserved jurisdiction method works

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Under the reserved jurisdiction method, the community property share of each pension payment is split between the former spouses at the time the payment is received.

Most family lawyers compute the community property share by multiplying the amount of each payment by the so-called community ratio: the length of time worked during marriage divided by the total length of time worked. This formula is simple and is based on the "time rule" mentioned above. (See fn. 5 and accompanying text.) Under the community ratio, if an employee works 50 months before marriage and 100 more months during marriage, quitting when the marriage ends, the community share of his pension payments will be two-thirds. If the same employee works 50 more months after the marriage ends and then quits, the community share will be only one-half, but his total pension rights should have become correspondingly more valuable.

Though the community ratio seems easy to apply, counsel must take care or its application will lead to serious inequities.

For example, in calculating the amount of time worked, counsel should be sure to include any period the employee had to work before he became eligible to participate in the pension plan. Even though the employee may not have received any pension credits for his work during that period, that work is as necessary to his earning pension rights as is any later work he performs. Also, under certain circumstances a pension plan may have to credit an employee for time spent in military service. (*Alabama Power Co. v. Davis* (1979) 431 U.S. 581.) That military service time should also be counted.

The community ratio should also be altered to adjust for the fact that the nonemployee spouse will receive his portion of the pension only during his life; if he predeceases the employee spouse, the employee spouse will receive the total pension for the years after the nonemployee spouse's death. (*Waite v. Waite* (1972) 6 Cal.3d 461, 472; *In re Marriage of Lionberger* (1979) 97 Cal.App.3d 56, 71.) Since the pension normally stops on the employee's death, the nonemployee spouse does not reap a corresponding benefit if he survives the employee spouse.

In *Waite*, the Supreme Court suggested that the nonemployee spouse might be given more community assets of other types to compensate for this inequality. (6 Cal.3d at p. 472.) No later case has provided any surer guidelines. Among the possible solutions are (1) a payment in cash or community assets to the nonemployee spouse at the time of dissolution in the amount of the then present value of the nonemployee's lost remainder interest, (2) an unequal division of the community share of each pension payment to offset the lost remainder, (3) a realignment of pension rights to give the nonemployee spouse an option upon the employee's death, or (4) an agreement that the nonemployee spouse's portion will be paid as his will directs after his death. Though the last alternative seems the simplest, it is also the riskiest and ought to be avoided. The agreement might be void as a prohibited assignment of the employee's benefits.

Another problem of the reserved jurisdiction method is figuring out when the pension payments should begin. If the employee spouse re-

tires at the earliest possible date (frequently age 50 for public plans and 55 for private plans); each monthly pension payment he receives will be smaller than if he retired later. However, he will receive those payments for much longer, so that the present value of the pension is often greatest if the employee retires at the first opportunity. For this reason, the courts have held that the nonemployee spouse should not be bound by the employee spouse's decision not to retire until later. The nonemployee spouse is entitled to his share of the community property portion of retirement payments when the employee spouse is first eligible to retire. (*In re Marriage of Luciano, supra*, 104 Cal.App.3d 956, 960; *In re Marriage of Martin* (1975) 50 Cal.App.3d 581, 584; *Bensing v. Bensing* (1972) 25 Cal.App.3d 889, 893.)

Consequently, if the reserved jurisdiction method is used, the nonemployee spouse's attorney must assure that any settlement or judgment allows the nonemployee spouse to demand division of the community property interest in the pension when the employee first becomes eligible to retire. The nonemployee spouse should be reminded that the early retirement date is a possible date for him to demand his share of the pension. It should also be explained, however, that in some cases it may be better to delay receiving the community property portion of the pension while spousal support is still being paid, so that when support ceases, the pension payments will be larger and will better compensate for the lost support payments.

What is supposed to happen when the nonemployee spouse demands his share of the pension at the early retirement date is a question the courts have not yet answered. Surely, the employee spouse cannot be forced to retire. Most plans will not pay benefits while the employee remains at work. Presumably, therefore, the employee must pay the nonemployee his proper portion of the pension from the employee's salary. Doing so will create a myriad of income tax problems: the nonemployee may be taxed on the payments as ordinary income; perhaps the employee may deduct such payments from his taxable income; alternatively, the employee might

exclude those amounts from income when he later receives actual pension payments; and if the plan is funded in part through the employee's contributions of already-taxed income, the tax difficulties become even more complicated. (See *Hardie & Reisman, supra* fn. 1.)

Pension plans often contain other options besides the early retirement option.<sup>10</sup> Like that option, the other options can also affect the amount the nonemployee spouse will receive. For this reason, any settlement or judgment should enjoin the employee from making, and the pension plan from accepting, any election of an option unless the non-employee spouse has first been given an adequate opportunity to find an attorney, negotiate an equal division of the newly elected benefits, and, if necessary, seek relief in court.

Sometimes it may be appropriate to require the employee spouse to elect a particular benefit, such as a joint-and-survivor annuity, as part of the settlement or judgment. If this is done, care must be taken to assure that the election is timely made in accordance with the plan's terms. In general, it is better to anticipate and provide for these problems before the employee spouse has acquired a new family and other obligations which may make other options look more attractive.

Because there are so many possible problems which may arise in the future under the reserved jurisdiction method, the court should retain jurisdiction over the case to make all orders necessary to effectuate the settlement or judgment. Also, to make sure that rights are fully protected, the judgment or settlement should require both spouses and the pension plan to keep one another notified of any changes of address or material changes in pension plan provisions. The spouses should also

be told that their lawyers will not receive such notices and will not be responsible for on-going supervision of the payment and division of the pension.

As can be seen, the reserved jurisdiction method of dividing pension rights on dissolution of marriage raises many problems not apparent from its deceptively simple formulation. Great care must be taken before recommending that pension rights be split according to this method. If it is chosen, the judgment or settlement must be carefully worded to protect the spouses against unintended and unfair results.

A series of sample sentences for inclusion in such a judgment or settlement is set forth below. For simplicity of reference it is assumed that the husband is the employee spouse.

There is a community interest in husband's pension plan with [name of pension plan].

Wife is entitled to one-half of that portion of the plan which is attributable to work performed or any other service or time credited on and after the date of marriage [date] and through and including the date of separation [date].

The court reserves jurisdiction to determine the nature, amount, date and method of payment of the community property share of the pension and to order husband or the pension plan to pay one-half of that share to wife commencing at or after such time as the court finds that husband is first entitled to receive pension benefits.

Wife shall not be paid her part of the community property share of the pension before she has filed a motion with this court for an order requiring such payment to begin.

The parties agree that at the time wife files a motion to require payments to begin, the court may appoint as its expert witness, [name of actuary], an actuary, or if he is unavailable, another qualified actuary. The appointed actuary shall report in writing detailing the various alternatives for payment to wife of such sums during husband's lifetime as will, based on probabilities, pay wife her one-half of the community property share of the pension. The parties shall share the cost of any such court-ordered report.

Husband shall not make, and the pension plan shall not accept, any elections, choices or other actions which in any way perfect or alter

husband's pension rights, except upon further order of this court after at least 90 days' written notice to wife. For good cause shown and on noticed motion, the court may shorten the 90-day notice period.

The pension plan shall notify wife in writing of any changes in the plan to the same extent as if she were a participant in the plan.

Each party, including the pension plan, shall notify the other two parties of any change in mailing address. All notices required by this [agreement/judgment], including notices of motion in the dissolution proceeding, shall be in writing and shall be served by certified mail to the last known address of the other parties.

In calculating the community property share of husband's pension payments, the gross amount of those payments, before any deductions, shall be used. To the extent then required by law, tax or other deductions, including withholding taxes, shall thereafter be deducted. Insofar as legally permitted, such deductions shall be calculated separately for the portion of the pension paid to wife.

If any portion of this [agreement/judgment] is rendered invalid, illegal, unconstitutional or otherwise unenforceable, the court reserves jurisdiction to make an appropriate adjustment to effectuate the intent of the parties.

If husband becomes disabled and is required or eligible to receive retirement benefits as a result, the court reserves jurisdiction to confirm to him as his separate property the portion of those benefits payable solely on account of his disability.

The court's reserved jurisdiction shall be liberally construed and shall include, for example, the power to compel the parties to make elections as to benefits at such time as may be necessary to effectuate an equal division of the community property interest in the pension.

As can be seen, division of pension rights on marital dissolution is not a simple matter. Neither is it impossibly complex. The family lawyer must be aware of the many problems which division of such rights may entail and take the necessary steps to assure that his client's rights to half of the community property share of the pension rights are properly protected.

<sup>10</sup>Typical of such additional options are the joint-and-survivor annuity and the lump sum settlement. Choice of the latter option can drastically reduce the nonemployee spouse's interest. (See, e.g., *Ball v. McDonnell Douglas Corp.* (1973) 30 Cal.App.3d 624.) While courts might have the power to make a reasonable, nondetrimental modification to a public pension (*In re Marriage of Brown, supra*, 15 Cal.3d at p. 849 fn. 11), there is no guarantee that courts will reverse the choice of options or the designation of beneficiaries by the employee spouse.



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