Divorce, Pensions and Retirement Benefits

Number: 33 Paul Commerford – President – LawDATA, Inc. August 2005

DEFINING DEFINED BENEFIT PENSION PLANS - A REFRESHER COURSE

Introduction:

Often, I am asked to justify the inclusion of defined benefit pension plans in the marital estate. Because most pension plans do not have a lump sum account balance attached to them, and can be characterized as speculative, it is difficult for the pension plan participant to see the real value their expectations might have. You can usually get past this by suggesting that a QDRO be used for distribution purposes if the participant really thinks it is speculative. But that is not the real answer. As an attorney you should be able to clearly explain the rationale for the inclusion of marital property pension income, not yet in pay status. Once that is understood, the parties can go on to decide what method to use in their situation; immediate offset or deferred by use of a Domestic Relations Order. You must be able to justify, to all, the rationale of pension value inclusion. Unless you succeed, the participant will not want to give up "real" assets, like additional home equity, for a "speculative" asset, such as a $30,000 per year pension starting at age 50 when he or she is only 40. Your ability to make all parties to the case comprehend the real value of the pension is critical to reaching an equitable distribution.

Practice Tip of the Month:

How do I distribute the present value of the marital portion of an accrued pension plan asset when the parties have limited assets and the plan is a government sponsored plan that refuses to accept Domestic Relations Orders?

You really only have two choices when you encounter a situation such as this. Either, you offset the present value of the pension benefit, through additional real estate or other assets being transferred to the non-participant spouse or, using the present value of the pension, you structure an amortized payout (with interest) over 5, 10 or 15 years. The most important thing is to structure the payout while the participant is still working so that if the court-awarded payment goes into default, the paycheck can be garnished. That way the non-participant can place a lien on the paycheck each pay period. Government employees rarely quit their jobs. If you wait until retirement and then expect the participant to pay the awarded share of each pension check directly to the non- participant spouse each month it is received, forget about it. You cannot get a judgment against the pension and because of the reduced monthly income provided by the pension, the participant will either renege, or fall far behind, on any commitment.

Always exhaust the immediate offset possibilities first. Having the participant assume a greater share of the marital debt or a higher child support or alimony burden are other alternative equitable distribution sources.

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All pension schemes are a form of deferred compensation that the employer obligates itself to provide to all employees as a condition of employment. Understanding this, it becomes obvious that they are joint assets earned during the marital period but not available as income to the couple until the future. It really equates to the parties having set aside a portion of their income for their retirement.

When the word “pension” is used what is usually meant is an entitlement to a monthly annuity for life commencing upon retirement. This monthly income is provided by a “defined benefit” plan. A government entity, the military, utility companies, most trade unions, larger industrial employers (G.M., General Electric, etc.) can all be, and usually are, “defined benefit” plan providers. In the case of most private pension plans, the employee makes no contribution to the accrual of his benefit. If the employee does, the contribution has no real relationship to the lump sum value of the employee’s projected pension at the time it goes into pay status. In other words, the employee does not really pay for the pension.

Most public pensions require a contribution from the employee. Public plans were started at a time when private pensions were rare and public employees were poorly paid. Requiring employee contributions as a funding component was an attempt to convince the taxpayer that the employee was paying for his own pension. Not so. At the time of retirement, the total value of a public employee’s contributions to the retirement plan, plus interest on those contributions, rarely exceeds 30% to 40% of the present value of the future pension income. All federal pensions and many state or local pensions, include built-in annual Cost of Living Allowances (COLA’s). If the plan provides a COLA and allows unreduced early retirement benefits (as most public employee plans do) then the ratio of contributions to the actual present value of the pension is much less than 30% to 40%.

The benefit to be received is determined by a formula such as final salary x years of service x 1.6% = annual pension payable to the retiree for life (i.e. $60,000 X 1.6% X 32.5 years = $31,200 annual pension for the life of the participant). There are no individual accounts in the name of the employee. Private pensions are funded by the company paying sufficient funds into a general account that is invested at a rate of return targeted to fund its future outstanding pension liabilities. Many public pensions have the employee contributions invested specifically to fund part of their pensions but still a large part of the public pension obligations are simply unfunded liabilities being paid currently, and in the future, by taxpayers from the general funds of the government entity.

Naturally, when investment returns are very high, as was the case throughout much of the 1990’s, providing a defined benefit plan, while costly to set up and administer, does not create a major financial burden for the private company employer. Conversely, when investment returns and interest on secured accounts dwindle to almost nothing (while at the same time the company’s profits are being hammered), as in the early 2000’s, these plans become very costly.

VESTING:

Under current federal ERISA regulations most employees of private companies have a vested right to receive their accrued defined benefit when they reach retirement age once they have five years of service. Even if they leave their jobs at a very young age, for any reason whatsoever, they will still have the right to this pension. They will be “vested”. The normal vesting period was reduced from ten years to five years on January 1, 1989.

There are other forms of vesting but "cliff vesting" is the most common. That means that participants have no right to their accrued benefits until they meet the plan's vesting requirement, usually five years. From that point on they have a 100% ownership interest in their accrued pension. Military plans differ from the norm in that there is no "vesting". A participant either serves his 20 years and is entitled to an immediate pension or leaves prior to that time and is entitled to nothing. Many public sector plans (and a few trade unions) still have ten year vesting. In most states it does not matter whether the pension is vested or not for it to be considered a marital asset and subject to distribution.

If an employee leaves a company and has accrued a vested defined benefit, the pension is "frozen" when he or she leaves. If the employee is 30 years old and leaves a deferred vested frozen benefit of $500.00 per month payable at age 65, that amount will not change at all for 35 years. There is no interest or other earnings added to a "frozen" defined benefit plan. By the time the participant is eligible to receive these funds, using historical perspectives, $500.00 per month might have the current purchasing power of as little as a $50.00 per month pension when measured against the purchasing power of the dollar when the benefit goes into pay status. Even in periods of very low inflation, because of the magic of compound interest, money loses about 50% of its purchasing power every ten years. Over a 35 year period the odds of there being no periods of high inflation (6% or more) are remote. If there were periods of really high inflation, as was the case in the late 1970's and the early 1980's, the erosion of purchasing power would decimate any fixed amount deferred vested pension benefit.

In divorce cases involving less employment then required for 100% "cliff" vesting it could be argued that equity requires a reduction of the present value of the pension for the possibility of termination before vesting. The appropriate reduction is subject to negotiation. In cases of which I am aware, using a ratio reduction factor such as 20% of the computed present value of the pension for each year of non-vesting for a participant in a plan with five year vesting, or 10% per year reduction if the vesting requirement is 10 years, has always seemed appropriate.

Using these reduction guidelines as a distribution factor, let's assume a 43-year-old male participant has three years of service in a pension plan with a 5-year vesting requirement. The pension plan will provide an income of $2,500.00 per month at age 60 if he continues his employment until that date (assuming no increases in salary when computing the age 60 benefit). The present value of the future pension is $163,770.05 but only 15.5761% or $25,508.99 of that value is marital property based on 36 months married while employed and 231 months of total employment at retirement on his 60th birthday. As he is not vested at all in his retirement benefit at this time and has accrued only 3 years of the five years he needs for 100% "cliff" vesting, it would be appropriate to reduce the marital property present value by 40% (2 X 20%) to take into consideration the possibility of leaving employment before vesting. What this means is the marital property subject to distribution would be $15,305.39 instead of $25,508.99. This is a more equitable approach in those situations where vesting is not a factor when deciding to include or not include retirement assets in the settlement. This approach is not the responsibility of the pension appraiser; rather, it is an issue that should be addressed by the attorneys in settlement negotiations.

Unless the present value of the employee's vested pension is less than $5,000.00 (computed on an actuarial basis) at the time the employee reaches retirement age, there are no provisions for a lump sum payout. Defined benefit pension payments are made on a monthly basis over the life of the participant.

FUNDING:

A division of the U.S. Department of Labor called the Pension Benefit Guaranty Corporation (PBGC) governs private pension plans. The plan provider is required to set

aside sufficient funds to pay for the current and future pensions of all of its covered employees. The amount of money needed to accomplish this is determined on an actuarial basis. Actuarial calculations take into consideration:

1. The average life expectancies of the plan participants in the company's employee and retiree population based on mortality tables published by insurance companies and government agencies. Unisex mortality adjustments are applied so that the amount paid to the participant is the same whether they are male or female. In the real world it costs more to fund female pensions because their life expectancy can be up to seven or more years longer than that of a male. The actual difference depends upon the age of the individual at the time the valuation is computed.
2. The anticipated rate of return on the funds set aside to fund the current and future pension payments.
3. The experience of the plan provider as to the number of employees who die or leave employment before qualifying for full pension benefits.
4. The costs incurred by the company incident to the management of the pension.

Included in the cost of managing the pension is the requirement that private plans have to make quarterly payments to the PBGC to fund a pension payment protection program for its employees. This program will pay the vested accrued basic pension (up to a statutory maximum - $ 45,613.68 per year in 2005 at age 65 and less if the participant retired prior to age 65 and is already receiving pension benefits and/or elects to provide survivor benefits for his or her spouse) owed to the participant in the event the company goes bankrupt, or suffers some other financial hardship. Historically, whenever this occurs, the company's pension trust fund account is under-funded and cannot meet its pension obligations. This is similar to the scheme set up by the Federal Deposit Insurance Corporation (FDIC) where banks are required to fund guaranteed protection for its depositors (up to a legislated maximum per each account) in the event a bank should fail.

SUPPLEMENTED DEFINED BENEFIT PLAN BENEFITS:

Many defined benefit pension plans offer long-term employees enhanced retirement benefits. These enhancements can take many forms but they usually involve early, unreduced benefits, which enable an employee to retire prior to his or her normal retirement age.

The most common normal retirement age for private plans is at age 65. Just about every private plan allows early-reduced retirement between age 55 and 65. These reductions are typically scaled to provide an employee with 50% of his accrued pension benefit earned to date at age 55. Each additional year of employment after age 55 increases the amount of the reduced, vested pension by 5% so that, at age 65, 100% of the vested pension will be paid. These reductions are in place in an attempt to offset the additional costs to the plan when the participant retires early and receives the pension over a much longer period of time. If you retire early with reduced benefits and the plan has no supplemented pension provisions, the monthly amount you receive will never increase unless the plan has a built in COLA. Very, very few private plans provide benefits with built in COLA adjustments. Only in government run defined benefit plans, with pensions funded by taxpayers, and where the legislators who write the rules are also plan participants, do you find this kind of employer generosity.

Supplemented pension benefits are structured to avoid the penalties incurred for early commencement of a participant's vested benefit. A typical enhancement might be that 100% of the accrued benefit will be paid when the combination of credited service and the participant's age total 85. This would allow an employee to retire with 100% of his accrued benefit at age 55 with 30 years of service or at age 60 with 25 years of service. These enhancements are put into place to encourage company loyalty and long-term service. Another targeted result is that supplements encourage higher paid employees to

retire early and make room for the next generation of workers. The workers who replace them usually have not yet reached the top salaries that the senior employees, eligible for supplemented benefits, are being paid. This movement out of senior people helps to retain the loyalty of younger workers because they can see opportunity for themselves in the future as the senior people take advantage of the available retirement incentives.

There are plans that offer "thirty and out" options. Employees can retire with unreduced benefits at any age once the employee accrued thirty years of service. Still others go further and offer "thirty and out" plus additional pension income until the employee reaches age 62 and qualifies for early Social Security benefits. Even better, some plans offer supplements until the employee qualifies for unreduced Social Security benefits. These supplemented benefits are very valuable and should be taken into account when valuing a pension or drafting a QDRO.

The earlier an employee can retire with unreduced benefits the more valuable the pension benefit is. When I say "valuable" what I am referring to is the amount of money needed, in a lump sum, to purchase a single premium annuity that would give an individual the same annual pension income as the annual pension being provided by the plan provider. Single premium lifetime annuities can be purchased from most life insurance companies.

A pension has its greatest lump sum value on the first day the participant can retire with unreduced benefits. Even though the pension will continue to increase after that date because of additional service and pay raises, its lump sum value will actually decrease. In addition once an employee reaches the date on which he can receive unreduced benefits, if he continues to work you could look upon any pension he could be receiving as the amount of salary reduction he has elected in lieu of not retiring. Theoretically, the employee takes a cut in the salary he is paid for working if he continues employment when he could be receiving unreduced pension benefits.

Supplemented pension benefits are not guaranteed by the PBGC. If a plan provider encounters financial hardship and defaults on it's pension obligations, only the un-supplemented portion of the pension benefit will be paid out of the employee pension plan protection funds maintained by the PBGC. This can create a real hardship for employees who had already elected to commence receiving supplemented early retirement benefits. The benefits currently being paid to them could be changed to reflect the actuarially reduced vested benefit that would have been paid if the employee had elected a reduced early retirement without supplemented early benefits.

Model Property Settlement Language

Download our settlement language form and let the experts at LawDATA, Inc. draft model property settlement language (http://www.lawdatainc.com/SetLanForm.pdf) that deals specifically with the pension plan to which the order is addressed and the facts of your case.

Mr. Commerford has been active in the valuation of pensions and the preparation of Domestic Relations Orders for his attorney clients since the founding of LawDATA, Inc. in 1984. He has presented Continuing Legal Education programs, dealing with the valuation and distribution of retirement assets incident to divorce cases, for State Bar Associations throughout the country and written many articles on the subject for legal publications.

For any questions or ideas for upcoming articles you can reach Paul Commerford at paul@lawdatainc.com.

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