Divorce, Pensions and Retirement Benefits

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VALUING DEFINED BENEFIT PENSION PLANS

Introduction:

This month we are going to revisit a subject that we discussed before - the implications of the methodology used to identify the marital portion of a defined benefit pension. This has a much greater bearing on whether the portion of the settlement involving retirement assets is equitable than any other factor. And, to add frustration to its relevance, more often than not it is out of your control. Still, as an attorney you have to understand the implications of valuation approaches to defined benefit pension plans to properly represent your client and advise them of the realties with which they are confronted. Avoiding expectations that cannot be realized goes a long way toward avoiding disappointed clients and the problems their disappointments can create for you. Also, I am always hopeful that this message will reach someone in a position to rectify some of the problems created by judges and legislatures responsible for these difficulties because of their lack of understanding of the issue of pensions and equity.

Tip of the Month:

COLA's and QDRO's

Many public and private pension plans provide annual Cost of Living Allowances (COLA's). These can either be fixed at a certain rate (i.e. Florida State Employee Plans 3%, Michigan State Employee Plans 3%, etc.) or based on the actual increase (or a portion thereof) in the Consumer Price Index (CPI) in the preceding year. For many years there was some controversy as to whether these increases should be included in the appraisal of the present value of a pension plan benefit. That was settled in September 1999 when the American Academy of Actuaries issued Actuarial Standard of Practice, No. 34, ACTUARIAL PRACTICE CONCERNING RETIREMENT PLAN BENEFITS IN DOMESTIC RELATIONS ACTIONS. In this standards ruling the Board said, "If the retirement plan automatically adjusts benefits for increases in the cost of living, the actuarial valuation should generally reflect expected future increases in benefits attributable to such cost-of-living adjustments." Based on that ruling, most present value pension valuations will include COLA's if they are provided by the plan. The case of COLA's and QDRO's can be quite different. The federal government will automatically apply COLA's on a pro rata basis to the portion of the pension awarded to the alternate payee unless the domestic relations order restricts the amount of the monthly benefit payable to the alternate payee to exclude COLA's. In many public, and most private plans, passive post-retirement increases (which includes COLA's and other adjustments applied to all pensioners based on plan changes or provisions and aren't an additional individually earned benefit of the participant) will not be paid to the alternate payee unless his or her inclusion in the adjusted post-retirement monthly pension income is specified in the QDRO.

VALUING DEFINED BENEFIT PENSION PLANS

When valuing the various potential retirement benefits an employee may have, it is the generally held view in the legal community that defined benefit plans (pensions) are the hardest to really get your arms around. What is being valued is, in many ways, a right to a future income that may or may not be a reality at the time of the divorce. The employee could die before ever becoming eligible to collect the pension. He or she could lose their job. The company could rethink their employee benefits programs and eliminate the defined benefit pension by completely retooling retirement benefits. To the employee, the pension has no real value at the time of the divorce so why should he or she have to pay hard cash or give up their financial interest in real marital assets for an interest in an asset that they may perceive as speculative.

All of the foregoing objections, on the part of the plan participant, have some basis in fact but, unfortunately, defined benefit pension assets are often the most valuable property in the marital estate. Federal and state laws mandate their inclusion in property distributions incident to divorce. When analyzed, the intent of the various state community property and equitable distribution statutes are in place to insure fairness in the marital property distribution process. There is no way that goal can be reached if one of the most valuable joint marital assets is excluded. If your case law is equitable, a Qualified Domestic Relations Order can answer most of the objections presented by the participant.

Now we get to the hard part. Once we get past the participant's objections we are then confronted with valuing an asset that may be perceived as having ethereal qualities to all involved in the divorce. The understanding by many appellate courts and state legislatures of the correct valuation methodology to be applied to defined benefit assets is, being kind, a little less than insightful. Many pensions have supplemental benefits that kick in when certain tenure criteria are met. A number of states (not the federal government) ignore supplemented benefits if the participant is not eligible for immediate retirement with supplemented benefits on the marital property accrual cut-off date. In most pension plans supplemented benefits are the most valuable part of the benefit. Under the guise of limiting the distribution to only the actual amount of the pension earned up to the marital property cut-off date, many judges and legislators refuse to accept that throughout the marital years the rights to receive these valuable supplemented benefits were also being accrued.

If a Qualified Domestic Relations Order is used, many states require the monthly pension income being awarded the non-participant spouse to never increase one cent even though payment won't begin for decades. The amount awarded the alternate payee is constantly losing value because of the ever-decreasing value of the dollar caused by inflation. But, the marital portion of the participants' share of the pension is constantly being adjusted to reflect this loss of purchasing power due to inflation. That is how pension plan formulas work. But many states refuse to face this reality when it comes to the non-participant's share. If I were a conspiracy theorist, I might consider it as germane to their decision making that the rule makers, and interpreters of the rules (legislators, judges, bureaucrats, etc.), are usually all plan participants in very generous state pension schemes.

VALUATION APPROACHES:

When valuing pensions there are two approaches that can be taken. The one used by the pension appraiser is dictated by state legislation and case law; while also considering the facts of the case.

1. Deferred vested pension appraisal - assumes the employee stops working on the marital property cut-off date and the benefit earned up until that date is the only part of the retirement asset valued for marital property distribution purposes. This is the case law in a minority of states. Application of that methodology can grossly underestimate the present value of the pension. It permits no consideration of supplemented, early retirement benefits and will always make settlement of the case more difficult if the attorneys and the parties are aware of the inequities created by use of deferred vested methodology.

There are, however, situations where a deferred vested approach can be appropriate. This is true when the employee's job is really threatened of if he or she has been laid off or quit. It is also appropriate when you settle the case using an immediate offset distribution if the employee works in industries where breaks in service are the norm (i.e., construction, entertainment, etc.) and it is impossible to project how much pension credit will be accrued in the future.

2. Matured full benefit pension appraisal - assumes the employee will continue to work until his or her earliest unreduced retirement date without any imputed increases in salary between the marital cut-off date and the retirement date. The present value of that benefit is then reduced by a coverture calculation to eliminate all spousal interest in the present value of the pension beyond the marital cut-off date.

If future benefits are speculative, such as in certain industries (i.e., construction, entertainment, etc.), this can be addressed in a Qualified Domestic Relations Order in states that permit matured full benefit distributions.

THE DILEMMA:

To illustrate the distribution problems created by the failure of the judicial and legislative communities to understand this issue let us look at a current participant in a hypothetical pension plan and the problems created by attempts to establish the value of the pension rights incident to a divorce. To make the inequity more obvious, assume the individual commenced employment at age 20 and is now 49 years of age. Under the provisions of this pension plan, employees can retire when they have 30 years of service with a supplemented pension. This is not a particularly unique situation as many private and most government plans have "30 and out" provisions of some kind. Using the example plan, the participant can, commencing at age 50 (one year from now) retire and receive approximately $32,400 per year until age 62 (when Social Security benefits begin) and then receive approximately $17,300 per year in pension payments until death. If, on the other hand, an individual were to leave employment on the marital property accrual cut-off date with 29 years service at age 49, they would only be entitled to an accrued pension of about $16,356 per year commencing at age 65 and continuing until death. The employee would not qualify for 30 and out benefits.

Assuming the marriage commenced prior to employment, which is the more appropriate assumption to use for pension appraisal purposes? Should we cut off the pension accrual on the marital property accrual cut-off appraisal date, thereby assuming no additional employment and no entitlement to the "thirty and out" provisions of the plan or should we assume continued employment and attainment of eligibility to the early supplemented pension? That is the dilemma that confronts every attorney when they are trying to resolve the marital property value of a defined benefit plan. Only in those cases where the participant is already retired or has left employment prior to retirement is this not an issue.

If the case law in your state requires the use of a deferred vested appraisal and you represent the non-participant spouse, unless you can convince the participant to do the "right thing" there is no way you can settle this case on an equitable basis. If appraisals of the foregoing hypothetical situations were made using Pension Benefit Guaranty Corporation (a division of the U.S. Dept. Of Labor) valuation data current as of May, 2003, you would see that using the 30 and out provisions of the plan would provide a marital property value of $351,940.09 which reflects that 97.12% of the present value is marital property at the point the participant is eligible to retire and begin to receive supplemented benefits. If we assume termination on the marital property accrual cut-off date (4-1-03) with 29 years of employment service the marital property (100%) present value of the pension benefit is only $76,291.14.

Assuming a 50-50 split of marital pension assets, the same pension is worth over $137,824.48 more to the non-participant spouse if we assume the employee continues to work one more year. We are not giving the spouse an interest in that additional year's employment because the coverture calculation backs out that additional year before the marital property portion of the present value is identified.

As bad as that scenario is, consider what would happen if you distributed the marital portion with a Qualified Domestic Relations Order in any of the many states that stop all marital interest in the retirement benefits on the marital property appraisal (accrual cut-off) date. The participant would begin receiving $2,700.00 per month at age 50 the spouse would get nothing. When the participant turns 62 his benefit would be cut to $1,441.66 per month when his early U.S. Social Security benefits commence. The spouse still gets nothing until the participant reaches age 65. If payment prior to that date were elected by the alternate payee (an option) substantial early retirement reductions would be applied to the alternate payee's benefit, even further reducing the alternate payee's retirement income.

This doesn't even consider that most UAW pensions for active retirees are adjusted every three years when new labor contracts are negotiated. In most states that require deferred vested pensions the alternate payee cannot participate in post-retirement increases until the alternate payee commences to receive the amount that had been awarded to him or her. In UAW plans these adjustments usually reflect the approximate consumer price increases (CPI) over the previous three years. So the reality is that when the participant reaches age 65, 15 years after retirement, using a CPI of only 2% per annum the original $17,300 will have increased to $23,283.52. If the alternate payee had been named beneficiary of the 50% survivor annuity in the Qualified Domestic Relations Order then the participant's benefit would be reduced by 10% to $20,955.17 or $1,746.26 per month.

When the participant reaches age 65 the alternate payee would commence receiving the awarded amount of the pension (50% of $16,356 less 10% to reflect the reduction for the survivor annuity designation), $7,360.20 per annum or $613.35 per month. This is the amount that would be subtracted from the participant's $1,746.26 per month. With survivor benefits, and using conservative growth assumptions, at age 65 the participant has been receiving supplemented benefits for 15 years, and now when the alternate payee begins getting the share of the benefit, $613.35, the participant's monthly benefit will be reduced to $1,132.91. Remember the participant worked only one more year for these benefits and 97.12% of the participant's retirement benefits were earned during the marriage.

If the alternate payee was not awarded survivor benefits, and she was female, the inequity becomes even more glaring. The portion awarded to her would be 50% of $16,356 or $8,478. Her amount would then be reduced by about 40% if she were the same age as the husband. This is because, as a female, she has about a 7-year greater life expectancy than a male and the plan would have to actuarially reduce her benefit so that she is not paid

out a pension with a present value greater than that of the husband's. The Retirement Equity Act of 1984 states that a plan cannot pay an alternate payee a benefit with a present value greater than the present value of the benefit they would have paid the participant. In this scenario at age 65 the husband would receive $14,805.52 per annum ($23,283.52 less $8,478) or $1,233.79 per month. The wife would have her annual benefit reduced to $5,086.80 or $423.90 per month. Let us not forget that the parties were married for 97.12% of the time the husband was accruing his pension. With a deferred vested distribution, instead of her getting 50% of that or 48.46% of the value of the pension, she only winds up getting 50% of 21.677% of the actual value of the pension or 10.838%.

While it is true that legislation and case law dictate how the pension will be distributed, understanding the obvious inequity created by deferred vested methodology can give the attorney for the non-participant spouse some ammunition to use in negotiating the other contested marital assets. Also, the better attorneys understand this complicated issue, the sooner some remedial action might be taken in those states where the judiciary and the legislature don't seem to grasp the concept of equity when dealing with defined benefit pensions.

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.

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