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Valuing Pension Benefits in Divorce

by William Napoli, Jr.¹

Pension benefits typically represent the largest marital asset in most divorce actions. There are two basic types of pension plans: defined benefit and defined contribution. A defined benefit pension plan typically defines the benefit payable at the participant's normal retirement age (i.e., age 65) as either a percentage of the participant's average salary at retirement times his number of years of credited service under the plan or as a fixed dollar amount times the participant's credited service. Under a defined contribution plan, such as a 401(k) plan, it is the contribution that is defined and the benefit payable will be equal to the participant's accumulated account balance at retirement. This article concentrates on the evaluation of defined benefit pension plans and the determination of the present values of these benefits subject to equitable distribution.

There are several important factors that must be considered when valuing a pension benefit:

- **Accrued Benefit:** The determination of the benefit earned as of the date of the evaluation;
- **Retirement Age:** The assumed age at which benefits will commence;
- **Mortality:** The mortality rates that should be used to determine the likelihood that the participant will be alive to receive future expected benefit payments; and
- **Discount Rate:** The interest rate used to discount future expected benefits.

Thus, to best represent his client, the prudent attorney will select his expert to value these benefits very carefully. While an expert's experience in performing evaluations is very important, probably more important are the expert's credentials in dealing with each of the above factors. As E. James Jennings and Jonathon Furdek wrote, "The odds in favor of an accurate appraisal increase tremendously when either an economist with a doctorate or an enrolled actuary evaluate the pension. Certified public accountants and/or certified financial planners have expertise in taxes or insurance and mutual fund recommendations but have limited formal training in issues associated with pension evaluation."¹ Jennings and Furdek both possess a Ph. D in economics and were Associate Professors of Economics at Purdue University and at the time they wrote their article.

Accrued Benefit

The accrued benefit as of the date of the evaluation is usually obtainable from the plan sponsor. The accrued benefit is usually based on the participant's salary history and credited service as of the date of the evaluation. The expert would have to provide the plan sponsor with an information release signed by the plan participant to obtain this information. However, in addition to obtaining the dollar amount of the accrued benefit, the expert

should also obtain a current summary of the plan provisions to determine what the current provisions are relative to:

- Vesting;
- Early retirement;
- Form of payment associated with the accrued benefit;
- Automatic cost-of-living provisions of the plan;

as well as any other provision that would impact the evaluation.

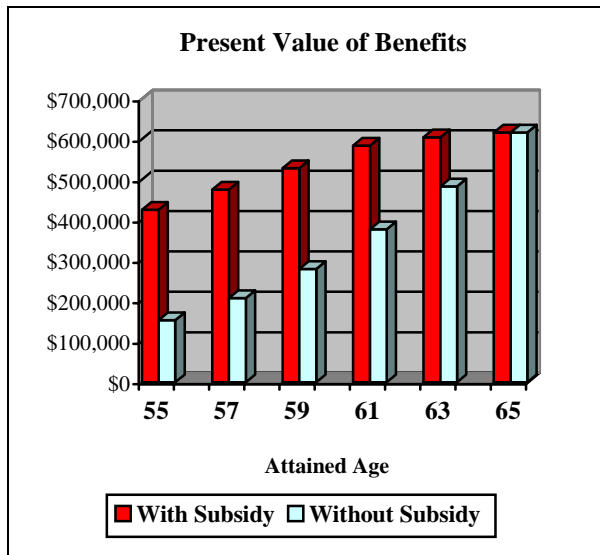
If the participant has already retired, in addition to obtaining the current monthly benefit, the form of payment and named beneficiary under the plans survivorship provisions should also be obtained.

As the Actuarial Standards of Practice No. 34 on Actuarial Practice Concerning Retirement Plan Benefits in Domestic Relations Actions indicates, the pension evaluation should contain a summary of the relevant retirement plan provisions including the benefit formulas, eligibility provisions for participation, vesting and retirement and pertinent optional forms of benefit payment.

Retirement Age

The age when benefits are assumed to commence is one of the most important assumptions in performing an evaluation. This is particularly true when the plan contains generous early retirement subsidies or supplements. An early retirement subsidy is when the plan either does not reduce the accrued normal retirement benefit if the participant retires early at some magic point such as the attainment of 30 years of service, or if the benefit is reduced only slightly. The following chart helps explain the value of early retirement subsidies. The shaded bar represents the present value of benefits, including the subsidy, if the participant retires early at the age shown. The white bar represents the present value of the benefits,

excluding the subsidy, since the participant is assumed to retire at age 65.



The excess of the shaded bar over the white bar represents the value of the early retirement subsidy.

An early retirement supplement is when an additional temporary benefit is paid from the early retirement age to some age, typically 62. If the participant is assumed to retire after the magic age, for example 62, the value of the supplement is ignored.

While it might be tempting, if the expert was retained for the non-participant spouse, to assume that the participant would retire at the age with the greatest value, this temptation should be resisted unless there has been testimony that would support this contention. It would be unfair to include the value of a significant early retirement subsidy or supplement that might never materialize. If this issue cannot be resolved, then a QDRO or similar Order should be used to assign the Alternate Payee benefits that would include the contingent early retirement subsidy and/or supplement.

Mortality

Various mortality tables have been used over the years to value the present value of

pension benefits. The standard tables used to determine lump sum cash-out options under qualified plans have changed over the years as summarized below:

- **PBGC Lump Sum Basis:** UP-84 Mortality Table set forward 1 year along with 4 interest rates:
 - i_0 = Interest rate at annuity starting date
 - i_1 = Interest rate for first 7 years of deferral
 - i_2 = Interest rate for next 8 years of deferral
 - i_3 = Interest rate for more than 15 years of deferral

These rates were used prior to 2000.

- **Old GATT Basis:** Between 2000 and 2002, the 1983 Unisex Group Annuity Mortality Table and interest based on 30-year Treasury bonds were used.
- **New GATT Basis:** Effective with the 2002 plan year, the 1994 Unisex Group Annuity Mortality Table Projected to 2002 and interest based on 30-year Treasury bonds have been used.
- **Proposed New Basis:** RP-2000 Combined Healthy Life Mortality Table possibly projected to the year of enactment with interest based on the corporate bond yield curve. Under this approach, one interest rate would be used for payments expected during first 5 years, another for next 15 years and finally a third rate for payments due 20 or more years in the future.

While these mortality rates may be appropriate if the plan provides for a lump sum cash-out of benefits to both the participant and alternate payee, care should be taken because qualified plans base their present values on a unisex basis. Thus, the lump sum basis would tend to overstate the present value for male participants who are usually expected to have shorter life expectancies than their female counterparts and understate the present value for female participants.

If the lump sum cash-out provision is not available to the alternate payee, then the present value should be based on the gender of the participant and should be based on a current mortality table such as the 1994 Group Annuity Mortality Table Projected to 2002 or the RP-2000 Combined Healthy Life Mortality Table. Either table could also be projected to a more current year as well. There is very little difference between the present value factors generated under these two tables. However, the present value factors generated under these two modern tables typically exceed the present value factors generated under the 1983 Group Annuity Mortality Table by 5%-8% for males and are almost equivalent for females if the same rate of interest is assumed.

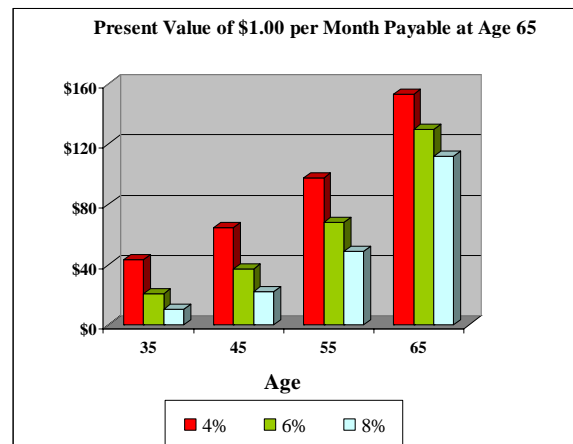
For individuals who are totally and permanently disabled, mortality assumptions should be based on special mortality rates such as the mortality rates required for qualified pension plans in determining the current liability (present value of accrued benefits) for participants eligible for Social Security disability benefits. For individuals who are disabled but who are not classified as totally and permanently disabled, additional mortality rates based on the healthy life table for an individual 3 years older seems appropriate.

It is worth noting that effective January 1, 2006 the PBGC values the liabilities for terminating pension plans using the 1994 Group Annuity Mortality Table Projected to 10 years after the year of the plan termination for healthy participants. For disabled participants they use the same basis indicated in the prior paragraph. In addition, the interest rate used by the PBGC in discounting benefit payments for the 20-year period immediately following the termination increased from 4.00% for December 2005 to 5.70% for January 2006. The new rates are remarkably close to the prevailing interest rates on high quality corporate bonds which leads us into the

discussion of the selection of the discount rate.

Discount Rate

Along with the retirement age assumption, this is a very important assumption. As the following chart illustrates, the impact of the interest rate on the present value of \$1.00 per month payable at age 65 is more significant at younger ages than at older ages. The impact of the interest rate chosen decreases for participants who are in payment status. For example, the present value at age 35 using 8% interest is only 23% of the present value using 4% interest while at age 65 the present value at 8% interest is 73% of the present value at 4% interest. Thus, much care must be taken in selecting the interest rate used to determine present values.



There are several issues that must be considered before selecting the discount rate:

- Actuarial Standards of Practice
- Plan Provisions
- Risk Factors
- Major Options

Actuarial Standards of Practice

The Actuarial Standard of Practice No. 34 indicates that the “discount rate selected for valuing retirement plan benefits in domestic relations actions should be a low-

risk rate of investment return, determined as of the measurement date based on the cash-flow pattern of benefits being valued ... a published index reflecting yield rates for high quality corporate bonds.” As an alternative, a survey of annuity rates could be used.

Plan Provisions

If the plan provides the lump sum option to the participant upon retirement, it would make sense that this basis be used to determine the lump sum value of the non-participant spouse’s assigned interest. Most qualified plans that offer the lump sum option base the lump sum on the New GATT Basis described earlier. However, current pending legislation would change the basis to high-quality corporate bond yield rates. Some state plans such as Ohio STRS and PERS use an 8% interest rate when discounting future benefits under the Partial Lump Sum Option (PLOP).

A court would be hard-pressed to explain why the present value of the non-participant spouse’s assigned interest should be based on a basis different than that used to determine the participant’s lump sum benefit.

Risk Factors

Every pension benefit incurs some element of “risk” that the pension benefits of the plan participant may not be fully guaranteed. Even the PBGC does not guarantee all benefits will be insured upon a plan termination. With the funding problems the PBGC has incurred in recent years, I believe it would be inappropriate to assume there is “no risk” associated with even those benefits that are potentially insured by the PBGC.

Thus, it would appear that to purchase an annuity for the non-working spouse would put her/him in a preferred position to that of the participant. If the SEC and the FASB are willing to use the Moody Aa basis as a “low risk” basis, why shouldn’t the divorce courts?

Some evaluators refer to the dictates of courts which call for domestic relations present values to reflect the cost of a replacement annuity. I wonder if they would advise any of their clients to purchase an annuity based on the rates used by the PBGC?

Is it fair that the plan participant has to give up real assets (house, cash, etc.) for a present value based on the assumption that the spouse will turn around and buy an annuity? Basically the participant is giving up a stream of payments that bears some risk and that is the way the present value should be determined. If the spouse uses the present value as an offset to obtain the house, for example, she incurs no risk in that transaction. Why then should the court accept inflated values as being a fair and equitable evaluation?

Major Options

There appears to be three major approaches used by pension evaluators to determine the present value of pension benefits. They are:

- Use of High Quality Corporate Bonds
- PBGC Annuity
- GATT

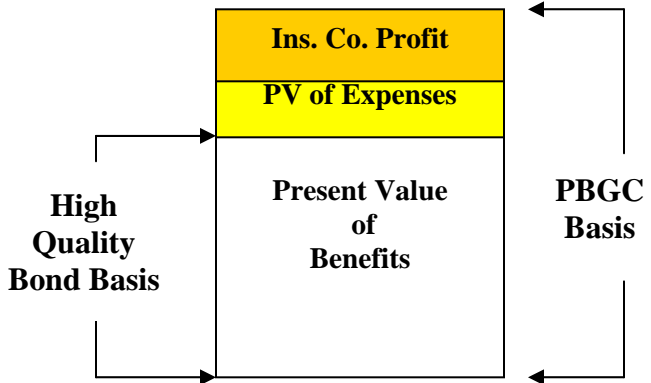
The use of high quality corporate bond rates is the same basis required by the Financial Accounting Standards Board (FASB) for the accounting of pension benefits in the determination of the present value of accumulated plan benefits in financial statements of corporations. Just as married couples going through a divorce list their assets and liabilities so do the sponsors of the pension plans. The unfunded value of the liability for accrued benefits appears as a liability on the plan sponsor’s balance sheet. Corporations usually base this liability on interest rates that approximate the Moody AA corporate bond interest rate. I should point out that the decision to use the Moody AA bond rates as the standard was not left up to corporate plan sponsors but was

referenced in 1993 by the Securities and Exchange Commission that they would not accept financial statements for publicly traded companies that were not based on interest rates inherent in high quality corporate bonds of grade AA or better. Why then should a more conservative basis be placed on the evaluation of the participant's benefits in a divorce? Should the benefit values assigned to the spouse be valued on a more conservative basis than those of the participant?

It should be pointed out that the Moody AA corporate bond rate is used for financial disclosure purposes and is not the interest rate that plan sponsors use for funding purposes. The interest rate used for funding purposes is based on the actual asset mix of the pension fund where typically 60% or more of the plan assets are invested in common stock. For example, the average interest rate for funding purposes typically falls in the 8.00% to 8.50% range.

Some evaluators state that the PBGC Annuity basis should be used to evaluate pension benefits. The PBGC, which publishes their rates monthly, base their rates on a survey conducted by the American Council of Life Insurers (ACLI) of large insurance companies that offer annuity contracts. The ACLI has stated that the majority of insurers surveyed indicated that as of March 31, 2002, they used a version of the 1994 Group Annuity Mortality Basic Table and project future improvements in mortality with projection scale AA. However, there are margins built into these annuity rates for insurance company profits as well as the administrative and sales cost associated with annuity contracts. Therefore, I do not feel they represent the "best estimate" of the present value of accrued pension benefits.

The following chart illustrates the problem with using the PBGC annuity basis for valuing pension benefits.



By their own admission, the PBGC has stated that these rates are conservative estimates of the present value of benefits for terminating plans and it was never intended that these factors be used to value pension benefits in divorce cases.

At the 2004 Enrolled Actuaries meeting I chaired a workshop on QDROs. I asked the group how many of them prepared evaluations for domestic relations cases. Every one in attendance raised their hand. Then I asked the group how many used the PBGC Annuity basis to value pension benefits and only 2 out of the 80 participants raised their hands. Many in attendance came up to me after the session and indicated they used corporate bond rates as their interest basis.

Three noted pension evaluators, William Troyan, Marvin Snider and Mark Altschuler all have expressed a preference for the use of the GATT basis in pension evaluations over the use of the PBGC Annuity basis, although Troyan indicated in his "Encyclopedia of Pension Evaluator Terminology for Divorce Cases" a preference to use the interest on the average of major corporate bonds since 2004. They seemed to be influenced by the methodology used by qualified plans to determine lump sum settlements. However, with the apparent shift of Congress to recommend high quality corporate bond yields to determine lump sum settlements in the future, it appears that now is the time to

recognize a new basis also in valuing pension benefits in divorce actions.

¹ William Napoli, Jr. is a Fellow of the Society of Actuaries, a Fellow of the Conference of Consulting Actuaries, a Member of the American Academy of Actuaries, and an Enrolled Actuary. He has over 35 years of pension consulting experience and has a B.S. degree in mathematics from Ohio State University.

² E. James Jennings and Jonathan Furdek, "When is a Pension Evaluation Worth the Paper it is Written On?" Res Gesta, March 1998, p.25.