



OVERVIEW OF THE DIVISION OF RETIREMENT BENEFITS IN DIVORCE – PART I

BY JOSEPH W. CUNNINGHAM, JD, CPA

Introduction

A. Under **Michigan law**, every judgment of divorce (JOD) must provide for the rights of the parties to both vested and unvested pensions, annuities, and retirement benefits. MCL 552.101(4)

1. Vested benefits must be taken into account in property settlements. MCL 552.18.
2. Unvested benefits may be considered “where just and equitable.” MCL 552.18

B. Age of specialization

1. Certainly applicable to handling retirement benefits in divorce.
2. Many **traps for the unwary**

C. As with taxation, the key is **awareness** of issues

1. Obtain necessary knowledge or assistance
2. Better serves clients and avoids unpleasant surprises down the road

Defined Benefit (DB) Plans

A. **DB Plans - Traditional pensions** – Monthly payment for life often based on (1) final average compensation, (2) years of service, and (3) plan formula.

1. E.g., \$3,500 a month for life.
2. Many units of government and large employers – such as the “Big 3 Automakers” - have DB plans.
3. But, the trend is definitely to defined contribution (DC) – or, “account balance” plans, such as 401(k) plans.

B. **Division** of interests in DB plans is achieved via (1) **offset method** or (2) **deferred division**.

1. Offset method involves (1) determining the present value of the pension and (2) awarding the other party property equal value.

E.g., The after-tax, present value of W’s pension is \$50,000. H shall receive \$50,000 of other property as an offset.

2. Deferred division refers to actually splitting the marital portion of the pension between the parties pursuant to a Qualified Domestic Relations Order.

E.g., H and W will equally share his \$4,000/month pension by means of assignment of half of his share to W pursuant to a QDRO.

C. **Offset method - Valuation**

1. Many professionals calculate the present value of a pension by using the discount rates published and updated monthly by the **Pension Benefit Guaranty Corporation (PBGC)**.
 - a. The PBGC, a federal government agency, uses the rates for the same purpose—that is, to determine the present value of future pension payments.
 - b. The updated monthly rates can be accessed at the PBGC website (www.pbgc.gov) by clicking on “Practitioners.”
2. Generally, it is appropriate to reduce the present value of the pension by the **tax** rate to which it will be subject when it becomes payable after retirement.
 - a. Rationale –The pension cannot be used in any beneficial way until received, at which time it is taxable.
 - b. The federal and state tax rates used to “tax affect” retirement benefits are those projected to apply after retirement.
 - c. Because of the certainty of taxation, case law supports valuing retirement interests net of future tax. *Nalevayko v Nalevayko*, 198 Mich App 163, 497 NW2d 533 (1993)
3. In some cases, there may not be sufficient other

property suitable to award the other party as an offset.

D. Deferred division method – QDROs/EDROs

1. As noted, deferred division of a pension for a divorce settlement is achieved by use of **Qualified Domestic Relations Orders (QDROs)** for qualified plans under federal law and **Eligible Domestic Relations Orders (EDROs)** for plans under the State of Michigan and local units of government in Michigan.
 - a. The party with the pension is “the participant”; the other party, “the alternate payee.”
 - b. The basic statutory requirements for QDROs under federal law, enacted in 1984 as part of the Retirement Equity Act, and EDROs, under state law enacted in 1991, are generally well known.
2. The emphasis in this presentation is on **issues and strategies** concerning QDROs and EDROs.

E. QDROS and EDROS

1. **Shared interests and separate interests** are alternative forms of a pension payment options which may be assigned from a participant to an alternate payee.
 - a. Under a **shared interest**, the participant and alternate payee both begin receiving benefits when the participant retires. Unless expressly excluded, the alternate payee will receive a survivor annuity after the participant’s death.
 - b. Example
 - At the time of divorce, W’s accrued benefit with ABC Co. is \$4,000/month-single life annuity (SLA) based on her life.
 - All her service with ABC occurred during the marriage.
 - As part of their divorce settlement, H and W agree to equally divide her pension as a joint and survivor (J&S) annuity via a QDRO.
 - The \$4,000 SLA is reduced to \$3,600 as a J&S benefit extending for their joint lives.
 - Each party receives \$1,800 while both live; the survivor continues to do so after the party dies.
 - c. With a shared interest, the alternate payee cannot begin drawing a benefit before the participant retires.
 - d. Under a **separate interest**, the alternate payee receives an annuity based on his or her life. As indicated above, the alternate payee can begin receiving a separate interest when the participant

reaches early retirement age under the plan regardless of whether the participant then retires.

- e. Determining **which option is beneficial** depends on the parties’ ages, their respective health conditions, and their financial situations.
 - f. Under both shared and separate interest payment options, it should be provided that the alternate payee is designated the **preretirement survivor beneficiary** to preserve his/her assigned interest if the participant dies before payments to the alternate payee begin.
 - g. Some plans require that the choice between a shared interest and a separate interest option be made in the QDRO (e.g., General Motors) while others accept QDROs providing that the alternate payee can elect either when he or she opts to draw the pension, based on prevailing circumstances.
 - h. **Practice Pointer** – If representing the alternate payee and the plan so allows, state in the JOD and the QDRO that the alternate payee can elect either a separate interest or shared interest.
 - i. Note that if the alternate payee elects a separate interest and draws the benefit early, based on the alternate payee’s life, the amount will be **actuarially reduced** (since it will be paid over a longer period of time).
2. **Survivor benefits** are significant benefits that should be suitably provided for in every QDRO/EDRO.
 - a. **Postretirement survivor benefit.** As indicated above, under a shared interest—or a “joint & survivor annuity,” the parties will share the benefit—often 50:50—while both live, and the survivor will continue to receive his/her share after the other party’s death. This is referred to as the postretirement survivor benefit.
 - b. Under a separate interest, there is no postretirement survivor benefit. Since each party draws a benefit based on his/her life.
 - c. Also as indicated, to protect the alternate payee, it is essential to provide in the QDRO/EDRO that he/she is designated the **preretirement survivor beneficiary** to preserve his/her assigned interest if the participant dies before payments begin.
 - d. Some plans provide for a **reversion** to the participant of the benefit assigned to the alternate payee if the latter dies before payments have begun (and some plans, even after payments have begun).

- e. **Practice Pointer** –If representing the participant, provide in the QDRO/EDRO for such a reversion to the extent allowed under the plan.
3. **Collateral pension benefits** include, inter alia, (1) early retirement subsidies, (2) cost of living adjustments (COLA), and (3) preretirement and postretirement survivor benefits.
- a. Under MCL 552.101(5), such collateral benefits are considered integral components of the pension and, as such, are included with the portion of the pension assigned pursuant to a QDRO or EDRO unless expressly excluded in the JOD.
- b. **Practice Pointer** – It is generally good practice to expressly include or exclude, as the case may be, in the settlement agreement and JOD each of the collateral benefits that the pension may include. This both (1) improves the chances the QDRO will be properly drafted and (2) avoids subsequent disputes over what was intended in settlement negotiations.
4. The **marital/separate portions of a pension** is typically calculated by application of a **coverture fraction**.
- a. Example
- Date of divorce – January 15, 2015
 - W’s date of hire at ABC Co. – January 15, 1990 – 25 years
 - Date of marriage – January 15, 1995 – 20 year
 - Coverture percentage – 80% - 20 years/25 years
 - W’s accrued benefit at DOD - \$4,000
 - Marital portion at DOD - \$3,200 (80% x \$4,000)
- b. In some instances it is appropriate to use as a **denominator** in the coverture fraction **years of service as of retirement vs. as of DOD**.
- (i) Rationale – many pensions are “**back-loaded**” – that is, a disproportionately greater share of a pension’s value at date of retirement is earned in the latter part of total years of service.
- (ii) And, since the early **foundation years** were necessary to get to the “richer” later years, no one year should be treated as more important in accruing the pension’s ultimate value than another.
- (iii) Assume W works 15 years after the divorce and her benefit at retirement is \$8,000/month – a total of 40 years of service.
- The coverture percentage using 40 as the denominator is 50% (20 years/40 years).
 - Thus, the marital portion is \$4,000 (50% x \$8,000) vs. \$3,200 when using years of service through DOD as the denominator.
- c. Because many pensions are back-loaded, some claim in second marriages that the marital portion is the **difference in the accrued benefit between DOM and DOD**.
- (i) Consider 40 years of service, a 5 year second marriage, and 50% of the pension’s value “earned” during those 5 years.
- (ii) This methodology disregards the fact that, as noted by the trial judge in the *Giesen* case – “**It takes the first years to get to the last years. No year is more important than the other.**”
5. **Recoupment** under State of Michigan law - EDROs
- a. If (1) the alternate payee under an EDRO draws his/her assigned benefit before the participant retires and (2) the participant continues to work past normal retirement age of 60, the **participant’s benefit will substantially reduced** for each year he/she works from age 60 to age 65.
- b. “Understanding Recoupment” published by the State of Michigan Office of Retirement Services (ORS). It is available at the ORS website. www.michigan.gov/ors
- c. The **example** in the ORS article is as follows:
- The participant in a State of Michigan plan has an accrued benefit of \$1,000 at DOD which is divided equally with the alternate payee pursuant to an EDRO.
 - If the participant and alternate payee commence benefit payments at the same time, participant’s \$1,000 benefit will be reduced by \$500 to provide the alternate payee’s benefit.
 - The same will occur if the alternate payee commences benefits before the participant and participant retires at 60 or before.
 - But, if the alternate payee draws before the participant and the latter works beyond age 60, his/her 50% share will be reduced each year of continued service until age 65 when

recoupment ceases. At age 65, the participant's share of the \$1,000 DOD accrued benefit would be around \$250 vs. \$500.

- d. A **method for avoiding** the pernicious results of **recoupment** is to provide that (1) the alternate payee cannot begin drawing benefits until the participant does so and (2) if the participant opts to work beyond age 60, he/she must pay the alternate payee taxable/deductible Section 71 payments equal to what the alternate payee could have drawn when the participant reached age 60.

About the Author

Joe Cunningham has over 25 years of experience specializing in financial and tax aspects of divorce, including business valuation, valuing and dividing retirement benefits, and developing settlement proposals. He has lectured extensively for ICLE, the Family Law Section, and the MACPA. Joe is also the author of numerous journal articles and chapters in family law treatises. His office is in Troy though his practice is statewide.