

An Actuary's Perspective on Occam's Razor and QDRO Confusions

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Property Settlement Agreement (PSA)

In a divorce a PSA *defines what is marital property and how it is to be divided* between the two parties.

Think of a Spectrum of Marital Property:

- At one end are things that can *literally be split*
 - Cash in a bank account. \$100,000 split fifty-fifty is \$50,000 each
 - Shares of stock. 2,000 shares of GM stock split seventy-thirty is 1,400 for one party and \$600 for the other. (You don't even need to know what the stock is worth.)

Property Settlement Agreement (PSA)

In a divorce a PSA *defines what is marital property and how it is to be divided* between the two parties.

Think of a Spectrum of Marital Property:

- Further down the Spectrum are things that *can't literally be split* but could be easily *sold and the money split*.
 - A car
 - A boat

Property Settlement Agreement (PSA)

In a divorce a PSA *defines what is marital property and how it is to be divided* between the two parties.

Think of a Spectrum of Marital Property:

- Even further down the Spectrum are things *that can't literally be split* and for whatever reason *can't be sold* but could be *valued easily*.

- A house

- A timeshare at the Cape

In exchange for giving up their shares of the house and the timeshare one party will get \$228,854 worth of something else they otherwise wouldn't get.

Property Settlement Agreement (PSA)

In a divorce a PSA *defines what is marital property and how it is to be divided* between the two parties.

Think of a Spectrum of Marital Property:

- At the far end of the Spectrum are things that *can't literally be split or sold or easily valued*
 - Stock in a privately held corporation
 - A rare family heirloom antique

Not just anybody can value such property. An expert is required. (An accountant for the stock. An antique expert for the antique.)

Property Settlement Agreement (PSA)

In a divorce a PSA *defines what is marital property and how it is to be divided* between the two parties.

No divorce attorney would put in a PSA a statement like,

“The antique grandfather clock given by great-great aunt Edna as a wedding gift will be divided equally between the two parties.”

The attorney would recognize that the clock cannot be “divided” and expert appraisal is needed to determine the value.

Each party might get their own appraisal and any difference will have to be hammered out.

Property Settlement Agreement (PSA)

In a divorce a PSA *defines what is marital property and how it is to be divided* between the two parties.

A **Defined Contribution (DC)** plan is at the end of the spectrum with cash and other cash-like assets; A DC plan is nothing more than a pot of money.

The Statement,

“The Defined Contribution plan account balance as of the date of the divorce will be shared equally by the two parties”

would not be subject to much misunderstanding.

Property Settlement Agreement (PSA)

In a divorce a PSA *defines what is marital property and how it is to be divided* between the two parties.

A big mistake made in a PSA is thinking that a *Defined Benefit (DB) plan benefit is at the same end of the spectrum as a DC plan benefit.*

In reality the DB plan benefit belongs at the end with the antiques.

Many a PSA has said something like,

“The Defined Benefit as of the date of the divorce is to be shared equally.”

Many a spouse or ex-spouse has had a rude awakening when it's time for the benefits to start.

What is a DB plan benefit?

It is *a promise to pay a specific amount to a particular person for life* after retirement. It is a *promise of future payments*.

1. \$500 per month payments to Joe as long as he lives.
2. Two \$250 per month payments to Joe as long as he lives.
3. \$250 per month payment to Joe as long as he lives and \$250 per month payment to someone not Joe as long as they live.

You don't need to be a pension actuary to see why 1 and 2 are the same promise but 3 is very different promise. (Even if the other person is Joe's identical twin.)

What is a DB plan benefit?

It is *a promise to pay a specific amount to a particular person for life* after retirement. It is a *promise of future payments*.

If the difference isn't clear consider

Door #1 - \$500 per month payments for life to Joe, age 65.

Door #2 - \$250 per month payments for life to Joe and \$250 per month payments for life to Joe's ex-wife Judy, age 45.

If you had been expecting for years for the deal behind Door #1 how would you feel about changing to Door #2?

Benefits from a DB plan cannot be assigned or alienated.

IRC Section 401(a)(13)(a)

This means that DB *benefits cannot be paid to anybody but the participant* who earned them.

Over time this anti-alienation rule has been stretched and today there are *two exceptions*.

Qualified Joint and Survivor Annuities (QJSA)

IRC Section 401(a)(11)

Qualified Domestic Relations Orders (QDRO)

IRC Section 401(a)(13)(B)

Benefits from a DB plan cannot be assigned or alienated.

IRC Section 401(a)(13)(a)

This means that *DB benefits cannot be paid to anybody but the participant* who earned them.

The law recognizes and supports the concept that *benefits earned while married are joint property*.

When a participant in a DB plan retires and is married the retirement benefit *must be paid in a form that provides survivor benefits*. This form is a QJSA.

(The Retirement Equity Act made QJSAs the rule rather than the exception. For benefits not to be paid in QJSA form the spouse must consent.)

Benefits from a DB plan cannot be assigned or alienated.

IRC Section 401(a)(13)(a)

If the spouse of a DB plan participant who retires has a right to share the retirement benefits then it is not a big jump to the idea that *an ex-spouse has a right to retirement benefits* that were earned during the marriage.

When a marriage is dissolved everybody is used to the reality that joint property must be divvied up. DB benefits earned while married is joint property. A QDRO recognizes this as an exception to the anti-alienation rule.

Benefits from a DB plan cannot be assigned or alienated.

IRC Section 401(a)(13)(a)

- A QJSA permits (requires) DB benefits to be payable to a spouse.
- A QDRO permits DB benefits to be payable to an ex-spouse. (QDROS can provide benefits to a child or other legal dependant For purposes of this discussion we will only consider ex-spouses.)

The anti-alienation rules has not been stretched so far as to permit DB benefits to be payable to the spouse of an ex-spouse. (Testamentary-like rights.)

A Domestic Relations Order (DRO) is a judgment that is made pursuant to a state domestic relations law that deals with the provisions of child support, alimony payments or marital property rights for the benefit of a spouse, former spouse, child or other dependant.

IRC Section 414(p)(1)(B)

A Qualified Domestic Relations Order (QDRO) is a DRO the creates or recognizes the right of an “Alternate Payee” to receive all or a portion of the benefits payable with respect to a participant under a pension plan and that provides certain information and meets certain conditions.

IRC Section 414(p)(1)(A)

The information that makes a DRO a QDRO is

- INFO1**- The name and mailing address of the Participant and Alternate Payee
- INFO2** – The dollar amount or percentage (or method for determining the amount or percentage) of the benefit to be paid to the Alternate Payee
- INFO3** – The number of payments or time period to which the order applies

IRC Section 414(p)(2)

The conditions that make a **DRO** a **QDRO** are

- COND1**- The order must not require a plan to provide any type or form of benefit, or any option, not otherwise provided.
- COND2** – The order must not require a plan to provide increased benefits.
- COND3** – The order must not require a plan to pay benefits to an Alternate Payee that are required to be paid to another Alternate Payee under another QDRO.

IRC Section 414(p)(3)

- COND4** – The order must not allow the plan to pay benefits in a form that would provide joint and survivor benefits to the Alternate Payee's subsequent spouse.

IRC Section 414(p)(4)(A)(iii)

From a pension actuary's perspective *COND2 is one item of particular interest* because if a pension actuary gets involved with a QDRO it is probably with respect to this condition.

COND2 gives much insight into INFO2, the another item a pension actuary might get involved with.

COND2 can be succinctly stated as,

“A QDRO can't make the plan experience a loss,”

and this is the guiding principle.

(While not explicitly prohibited, a QDRO should not make the plan experience a gain either. A gain would mean *that somebody got short-changed* and that could lead to trouble later for one of the attorney(s), for example.)

There is the legal definition of a QDRO. But a **working definition is:**

“A QDRO is the means by which the relevant terms of the PSA are communicated to the Plan Administrator so they can be implemented.”

Despite the impressive Federal statutory origins of a QDRO it is important to remember that *the PSA is a “higher authority.”* All the work the pension actuary does actually belongs in the PSA stage of the process. *Translating the PSA into a QDRO is then just an administrative task.*

Once finalized the *PSA is binding* and cannot be changed without the consent of both parties. (The time the QDRO is prepared is not a good time to discover problems with the PSA.)

Consider a DC plan with \$216,000 in it that is considered marital property.

Anybody would recognize the problem with the terms of a PSA that give \$108,000 to the Participant and \$162,000 to the Alternate Payee. COND2 is clearly violated and these terms could not appear in a QDRO.

If the object was to “split the benefit equally” then each party must get \$106,000.

Consider a DB plan with a \$1,800 per month life annuity benefit that is considered marital property.

Who would recognize a possible flaw in a PSA that “splits the benefit equally” by giving a \$900 life annuity to each party?

(If these terms made it into the proposed QDRO there could be much trouble.)

Let's flesh out the example and see how it could be flawed.
(This example might be a bit extreme but it is to illustrate a point.)

Participant: 65-year old male

Alternate Payee: 45-year old female

Selected Present Value Factors: PVf_{45}^{45} : 15.0
 PVf_{65}^{65} : 10.0

The value of the benefit to the Participant is:

$$12 \times \$1,800 \times 10.0 = \$216,000$$

A PSA that “splits the benefit equally” by awarding each a \$900 life annuity could not be translated into a QDRO.

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The value of the benefit to the Participant is:

$$12 \times \$900 \times 10.0 = \$108,000$$

The value of the benefit to the Alternate Payee is:

$$12 \times \$900 \times 15.0 = \$162,000$$

The PSA turned a benefit with a value of \$216,000 into a benefit worth \$270,000. It was clear to anybody that the DC example was flawed and now it is clear that this DB example is equally flawed. (But maybe a pension actuary was necessary to uncover the flaw.)

Understanding the nature of the problem gives insight into solutions.

1. \$900 to Participant and \$600 to Alternate Payee.
2. \$900 to Alternate Payee and \$450 to Participant.
3. \$720 to Alternate Payee and \$720 to Participant.

Without an understanding of the present value nature of COND2 there will be misunderstandings, disappointments, possibly lawsuits,....

Occam's Razor

Pluralitis non est podenda sine neccesiate, or

Entities should not be multiplied beyond necessity, or

One should not increase beyond what is necessary the number of entities required to explain anything, or

The simpler the solution to a problem the better, or

KISS

There are many opportunities to apply Occam's Razor in the context of PSAs and QDROs. (To everyone's advantage.)

The first opportunity to apply The Razor in a divorce is at very beginning, when the PSA is being contemplated.

Is the purpose of the PSA **Division of Assets** (property-type) or **Provision for Income** (alimony-type) with respect to the retirement benefit?

QDROs can be complicated. Even beyond the administrative complexities (information and condition requirements) they can be difficult to administer if only because they can span 10, 20 or more years. The Razor says to *avoid them if you can.*

If both parties are agreeable to a *Division of Assets* PSA then a *QDRO may not be necessary.* If *Provision for Income* is required then a *QDRO is probably necessary.*

(The Razor doesn't say the simplest solution is the "correct" one or the only one.)

For a Division of Asset PSA the DB plan benefit is just another piece of property. (But remember where it is on the Spectrum of Marital Property.) It must be valued because the value isn't obvious like a DC account balance.

What is the asset? It is a *stream of potential future cash payments*.

How is the value determined?

You at least need assumptions with respect to *probability of payment* and the *time-value of money*.

Possible assumptions are:

- No mortality before retirement, a 25-year payout after retirement and 6% interest.
- No mortality before retirement, 94GAR mortality after retirement, 8% interest before retirement and 6% interest after retirement.
- 1983 GAM sex-distinct mortality with a 5 year age setback before and after retirement and interest using a high-quality corporate bond yield curve.
- Mortality based on a study commissioned for this particular purpose and stochastic modeling of future interest rates.

There is no single right answer. Each side might have its own actuary as expert to value the asset that is the pension benefit.

Different actuaries could come up with different values.

The two sides will ultimately have to come to an agreement for the Division of Assets to work and the QDRO be avoided.

COND2 (a QDRO can't make the plan experience a gain or a loss) is ***not applicable if there is no QDRO.***

If there is a QDRO then COND2 provides a lot of guidance with respect to what assumptions to use to determine the value.

In the absence of this guidance an actuary is still guided by the Code of Professional Conduct and any assumptions and methods used must be reasonable.

If there is QDRO then whether or not the plan experiences a loss is *determined based on the plan's assumptions*.

If the plan's definition of actuarial equivalence for optional annuity forms is 7.5% and UP84 mortality then these are the assumptions to use to be sure the value of the annuity benefit before division is the same as the value of the two annuity benefits after division.

Separate Interest QDRO

After the benefit is split the *Participant and Alternate Payee are literally separate participants*. Alternate Payee may choose an annuity start date and any payment option available under the plan (except one that provides joint and survivor benefits.)

Shared Payment QDRO

This is an *alimony-like arrangement*. Only when Participant begins receiving benefits does Alternate Payee begin receiving their share. When Participant dies payments to Alternate Payee cease. (However, Alternate Payee could receive the QJSA portion of all or a portion of Alternate Payee's benefit).

The details will be in the PSA. The QDRO merely communicates the PSA to the Plan Administrator.

The opportunity for confusion, complexities, assumptions and applying The Razor are numerous and often not easy for the inexperienced to spot. This is particularly true for a Separate Interest QDRO.

Any attorney handling a divorce in which a DB benefit is marital property would be well-advised to consult with a pension actuary to get an expert appraisal of the value and how to split it.

If you are a pension actuary consulted on a QDRO be mindful of the Code of Conduct and applicable Standard(s) of Practice. Watch out for conflicts of interest.

Splitting the DB benefit that is marital property is not the whole challenge. *Determining the DB benefit that is marital property is another, separate challenge.*

Fractional Method.

For example if Participant earned the benefit over 10 years and was married to Alternate Payee for 7 years then the marital property is 7/10ths of the benefit.

What benefit?

The benefit accrued as of the date of the divorce?

The benefit that is ultimately, actually paid?

The PSA is the time to address such details, not the QDRO.

Splitting the DB benefit that is marital property is not the whole challenge. *Determining the DB benefit that is marital property is another, separate challenge.*

Direct Method

For example Participant's benefit was \$X when Participant and Alternate Payee were married. When they are divorced 7 years later the benefit is \$Y. The benefit that is marital property is \$Y - \$X.

What benefit?

The benefit accrued as of the date of the divorce?

The benefit that is ultimately, actually paid?

The PSA is the time to address such details, not the QDRO.

Other details to worry about:

- Early retirement subsidies
- Future increases in benefits due to salary increases
- Future increases in benefits due to retroactive benefit increases.
- Joint and Survivor benefits on the Participant's portion of the benefit that is marital property.
- Cost of living increases.

These and other details should be addressed in the PSA. Transferring them to a QDRO is an administrative task. Problems with the PSA may not be able to be fixed in the QDRO.

Additional Sources of Information and Guidance

- “Divorce Orders & PBGC” www.pbgc.gov
- IRS Notice 97-11 “Providing Sample Language for a Qualified Domestic Relations Order”
- DOL publication, “QDROs – The Division of Pensions Through Qualified Domestic Relations Orders”
www.dol.gov/ebsa/publications/qdros.html
- Actuarial Standard of Practice No. 34 – “Actuarial Practice Concerning Retirement Plan Benefits in Domestic Relations Actions”
- Google “QDRO” and see what comes up.
- Occam’s Razor attributed to medieval English philosopher and Franciscan monk William of Ockham (1285 – 1349)