

Surely You Jest While I Vest Pension Valuation In A Tennessee Divorce

As Published in *Memphis Lawyer*, January/February 2003
The Magazine of the Memphis Bar Association

By Robert Vance, CPA, CVA, CFP

A pension plan can be the most significant asset that accumulates during a marriage. Couples often forego other forms of savings while vesting in an employer-sponsored plan since it is a “free” fringe benefit. The term, vested, means, “the degree to which an employee-participant owns the benefits which have been accrued on his or her behalf.”¹ It stands to reason that a pension, whether vested or not, should always be considered a valuable marital asset in a divorce. The Court of Appeals of Tennessee at Knoxville agrees with this premise. The Court ruled April 23, 2002 on the divorce case of Curtis Michael Daniels v. Mary Freels Daniels. The parties appealed several issues, one of which was whether the Trial Court erred in failing to award Mrs. Daniels any share of Mr. Daniels’ pension benefits. This article will focus on the Daniels decision and the methods the Court restates are to be used in valuing **vested and unvested (or undetermined)** defined benefit pensions in Tennessee divorces, however, different cases and circumstances may require different methods and techniques.

Daniels v. Daniels

As of the trial date, Mr. Daniels had been an employee of the Tennessee Valley Authority (TVA) for over twenty years. At trial, an affidavit from Robert J. Vaughn, manager of Retirement Services at TVA, was presented stating that if Mr. Daniels retires from TVA after five or more years of creditable TVA service, he may be eligible to receive a pension based solely on TVA’s contributions. He also stated, “the amount of any pension to which Mr. Daniels may become eligible has not been determined by TVARS and is not contained in any record maintained by Retirement Services.” The Trial Court apparently took this statement to mean that the pension was **unvested** and even used that particular term in describing the pension. This case, however, appears to center around **undetermined** benefits, not unvested.

In researching this article, I spoke with Mr. Vaughn at TVA. He issues the pension affidavits almost daily and assures me that in a situation as seen in this case, a TVA employee with twenty years of creditable service would be vested in the TVARS pension. He said that any vested employee could easily obtain a statement from TVARS estimating his monthly retirement benefit based on service already performed. TVA’s standard affidavit states that an employee’s eligible pension has not been determined and TVA does not maintain a record of it. Mrs. Selma Paty, attorney for Mrs. Daniels, told me this is technically true since TVA outsources the generation of the statements to a private firm and does not actually keep copies in their files. She agrees that the pension benefit information could have been easily obtained, but the Trial Court would not compel Mr. Daniels or TVA to produce the document.

In the appeal, Mrs. Daniels argued that the TVA pension is marital property pursuant to T.C.A. §36-4-121(b)(1)(B), which states:

¹ Slimmon, Robert F., Successful Pension Design For Small to Medium-Sized Businesses, (Englewood Cliffs, N.J.: Prentice-Hall, 1987), p. 25.

“Marital property” includes income from, and any increase in value during the marriage of, property determined to be separate property in accordance with subdivision (b)(2) if each party substantially contributed to its preservation and appreciation, and the value of vested and unvested pension, vested or unvested stock option rights, retirement or other fringe benefit rights relating to employment that accrued during the period of the marriage.

Mrs. Daniels also asserted and that the Trial Court abused its discretion in failing to award her any portion of the TVA pension that accrued during her husband’s twenty year career with TVA. Mr. Daniels argued that his potential collection of the unvested pension is based upon a number of future events and that Mrs. Daniels failed to produce any evidence as to the value of the pension or that he will even receive the pension. Mrs. Paty asserts that many attempts were made to produce the evidence of value, but Mr. Daniels would not cooperate and the Trial Court did not compel him to do so.

The Appeals Court found the pension to be a marital asset because of T.C.A. §36-4-121(b)(1)(B). The Court stated that, while Mr. Daniels’s pension is contingent upon several factors including but not limited to his retirement from TVA, the pension is a valuable marital asset assuming he qualifies for it upon retirement. They further found that the Trial Court did not divide the pension and it erred in failing to award Mrs. Daniels any portion of it. Although the Trial Court referred to the pension as **unvested**, it is actually **undetermined** since it apparently is vested based upon TVA parameters, but was simply left **unvalued** at trial.

The Appeals Court cited *Cohen v. Cohen*, 937 S.W.2d 823, 830-832 (Tenn. 1996). In *Cohen*, the Supreme Court stated that the difficulty in determining the value of pension or retirement benefits should not affect the classification of the property. Having held that unvested retirement benefits are marital property under the Tennessee statute, the Court in *Cohen* listed principles that may assist trial judges in valuing these benefits. The Court then went on to cite observations made by the Court of Appeals in *Kendrick v. Kendrick*, 902 S.W. 2d 918, 922 (Tenn. App. 1994) as follows:

1. Only the portion of retirement benefits accrued during the marriage are marital property subject to equitable division,
2. Retirement benefits accrued during the marriage are marital property subject to equitable division even though the non-employee spouse did not contribute to the increase in their value,
3. The value of retirement benefits must be determined at a date as near as possible to the date of the divorce.

Cohen v. Cohen specifically directs the Trial Courts as to possible methods of dividing an **unvested** or **undetermined** pension.

Vested “The first approach, known as the present cash value method, requires the trial court to place a present value on the retirement benefit as of the date of the final decree...To determine the present cash value, the anticipated number of months the employee spouse will collect the benefits (based on life expectancy) is multiplied by the current retirement benefit payable under the plan...This gross benefit figure is then discounted to present value allowing for various factors such as mortality, interest, inflation, and any applicable taxes...Once the present cash value is calculated, the court may award the retirement benefits to the employee-spouse and offset that award by distributing to the other spouse some portion of the marital estate that is equivalent to the spouse's share of the retirement interest...The present cash value method is preferable if the employee-spouse's retirement benefits can be accurately valued, if retirement is likely to occur in the near future, and if the marital estate includes sufficient assets to offset the award.”²

² *Cohen v. Cohen*, 937 S.W.2d 823, 830-832 (Tenn. 1996).

Unvested/Undetermined “In other circumstances in which the vesting or maturation is uncertain or in which the retirement benefit is the parties' greatest or only economic asset, courts have used the **"deferred distribution"** or "retained jurisdiction" method to distribute unvested retirement benefits. This method has distinct advantages when the risk of forfeiture is great...Under such an approach, it is unnecessary to determine the present value of the retirement benefit. Rather, the court may determine the formula for dividing the monthly benefit at the time of the decree, but delay the actual distribution until the benefits become payable...The marital property interest is often expressed as a fraction or a percentage of the employee spouse's monthly benefit. The percentage may be derived by dividing the number of months of the marriage during which the benefits accrued by the total number of months during which the retirement benefits accumulate before being paid. One advantage to the deferred distribution method is that it allows an equitable division without requiring present payment for a benefit not yet realized and potentially never obtained... Another advantage to the approach is that it equally apportions any risk of forfeiture...While the parties are entitled to an equitable division of their marital property, that division need not be mathematically precise...It must, however, reflect essential fairness in light of the facts of the case.”³

The Daniels Appeals Court stated that both the Supreme Court in *Cohen v. Cohen* and their Court in *Kendrick v. Kendrick* had already addressed the unvested pension issue in both cases. The Court therefore remanded to the Trial Court to choose one of the two aforementioned methods of valuation found in *Cohen* in order to obtain an equitable division.

Using the Present Value Method To Value An Interest In A Defined Benefit Pension Plan (Vested Benefits)

Many businesses, large and small, sponsor retirement plans that can be classified into generic categories as defined by the retirement plan industry and the Internal Revenue Code (IRC) as defined *contribution* plans and defined *benefit* plans. Participants in **defined contribution** plans (including IRA, 401(k), and Keogh accounts) usually receive periodic statements of their accounts that detail vested and non-vested balances. It is usually a simple matter to determine the values of investments in such plans since these are contributory accounts having a definite dollar figure “deposited” or contributed to the account owned by the employee.

A more challenging endeavor is determining the value of an employee's interest in a **defined benefit** plan since the value of the participant's interest in such a plan must be calculated by determining the present value of the expected future monthly pension payments, as prescribed in *Cohen*. The concept of present value must be understood in order to appreciate the pension valuation process. Present value embodies the concept that a dollar in hand today is worth more than a dollar a year from now, or many years from now. One would rather receive a lump sum of money now rather than waiting for it to be paid over a period of months or years. This preference lies in the **time value of money**, and, in order to receive a lump sum now rather than throughout the future, one must be willing to receive a reduced or “discounted” amount. The future benefits are discounted back to the present value using a number of variables that include a time period (the participant's life expectancy) and an assumed rate of return on the money (the discount rate).

The valuation process usually follows these general steps:⁴

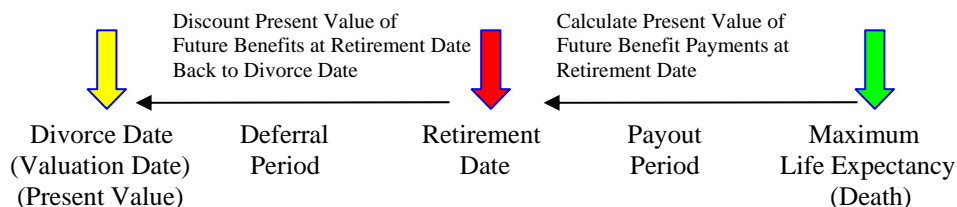
1. Establish the vested monthly retirement benefit as close to the Divorce Date as possible,
2. Determine the age and life expectancy of the participant,

³ Ibid.

⁴ Meltzer, Stanton L., et al., Guide to Divorce Engagements, (Fort Worth, TX: Practitioners Publishing Co., 1997), p. 5-63.

3. Determine the appropriate discount rate to be applied,
4. Calculate the present value of the future benefit payments at the Retirement Date,
5. Discount the present value of future benefits at the Retirement Date (as computed in Step 4) back to the Divorce Date (a.k.a. valuation date),
6. Determine what percentage of the computed pension value qualifies as marital property.

Pension Plan Valuation Timeline



- Payout period - Life Expectancy at Divorce Date minus age at Retirement Date
- Deferral period - Age at Retirement Date minus age at Divorce Date

Step 1 - Establish the vested monthly retirement benefit as close to the divorce date as possible

Most companies have an in-house pension administrator or outside administration firm that can readily calculate the expected monthly or annual benefit a participant will receive upon retirement, based on the benefit formulas established by the company. As previously stated, the value of a participant's interest in a pension plan is determined, for divorce purposes, by calculating the present value of the expected future monthly pension payments based on a life expectancy assumption. Quite often the benefit will be presented on a company-generated form as a dollar figure to be received monthly upon retirement at a normal retirement age and sometimes as a reduced amount upon early retirement (if that is an option in the plan). The statement may further break down the figures as a single life annuity (payments for the employee's life only) and a joint life annuity (payments for the lives of both spouses). For divorce purposes, only the single life option is used since a divorce is imminent and the joint life option will not be relevant (at least not for this spouse).

Step 2 - Determine the age and life expectancy of the participant

The participant's life expectancy is a figure in years that is calculated generically based on national statistics. The figures can be obtained from many sources. A commonly used source is the National Vital Statistics Report, from the Centers for Disease Control and Prevention. This application is quite simple. For example, a white male the age of 46 today, can be expected to live another 31 years to age 77, according to the tables. If he is to retire at age 65, the payout period is assumed/estimated to be 12 years (77-65) and the Deferral Period would be 19 years (65-46), for a span of 31 years (12+19).

Step 3 - Determine the Appropriate Discount Rate To Be Applied

In determining the appropriate discount rate, the following two components are considered:

1. The rate of return on risk-free investments, plus
2. An additional percentage of return intended to compensate the "investor" for risk over and above the risk-free investments, if any, associated with the specific pension plan being valued.

Risk-free Rate of Return

The risk-free rate refers to the investment return on a "perfectly safe" investment under current market conditions. This return and its underlying investment are based on the current yield of long-term U.S. Government bonds as of the valuation date. The maturity of the bonds should approximately match the

total period over which benefits will be discounted (the combined deferral and payout periods previously discussed).

Additional Risk Component

Many pensions are considered to be risk-free based on the size and success of the sponsor company, and those of the U.S. Government. The valuer may believe, however, that a risk may exist that the promised future benefits could be less than expected. The higher the perceived risk that payments will not be paid in full, the higher the discount rate should be. In other words, if more risk were involved with the cash flow being discounted, one would require a higher rate of return on the money to compensate for the potential default. As the discount rate goes up with the risk assessment, the present value will go down. The inverse effect occurs because one is “trading” away the risk into the future by “receiving” a lump sum now. The primary factors to consider in assessing the additional risk for a particular plan are as follows:

1. Is the plan covered under the Employee Retirement Income Security Act of 1974 (ERISA)?
2. Is the plan over or under-funded by the company based on the projected future obligations?
3. Is the company financially strong and currently successful?

Step 4 - Calculate the present value of the future benefit payments at the Retirement Date

Review the timeline presented above once more. The discounting of the present value of the future benefit payments begins to the right, in the Payout Period. The payments to be received monthly during this time period are to be calculated into a single lump-sum figure at the Retirement Date using a computer program. The future payments to the right are “pulled back” to the left closer to present day.

Step 5 - Discount the present value of future benefits at the Retirement Date (as computed in Step 4) back to the Divorce Date

After discounting the monthly payments into a single, lump-sum payment at the Retirement Date, the figure is then discounted to the Divorce Date to account for that time delay and the time value of money during the Deferral Period. After this figure is calculated, compare that value to any known contributions the participant may have made himself, plus earnings on those contributions. The larger of the two should be used as the present value of the pension.

Step 6 - Determine what percentage of the computed pension value qualifies as marital property

T.C.A. §36-4-121(b)(1)(B) defines marital property in part, as “the retirement or other fringe benefit rights relating to employment that accrued during the period of the marriage.” An easily understood approach to the calculating the portion of the pension that accrued during the period of the marriage is to calculate the ratio of the years of the marriage to the years of participation in the plan. For example, if the marriage lasted 10 years and the employee participated in the pension plan for 15 years, the value derived in Step 5 would be multiplied by 66.7% (10 / 15) to extract the marital value.

Present Value Method Example

Mr. Smith, age 47, who has worked for the ABC Widget Company for 17 years (since age 30), is divorcing his wife of 10 years. He has been eligible and has participated in the company’s defined benefit pension plan for the last 15 years. During discovery, a pension benefit estimate is obtained from ABC that states Mr. Smith is fully vested in the plan and will receive \$680 per month upon retirement at age 65. The figure is based on the company’s pension formula using variables known as of today with no assumptions of future service or salary projections.

Using the appropriate table in the National Vital Statistics Report, it is determined that Mr. Smith has a life expectancy of 31 years (i.e. he is expected statistically to live until age 77). The Payout Period to use is 12 years (77-65) and the Deferral Period is 19 years (65-46). The current interest rate quoted on 30-year U.S. Government bonds (the risk-free rate) is 5.5%. After analysis of the ABC Widget Com-

pany, it is determined that their plan is covered under ERISA, the plan is slightly under-funded and the company is experiencing some lean financial times according to the latest annual report. An additional risk of 1% is determined to be appropriate under the circumstances, for a total 6.5% discount rate.

The current expected payout of \$680 per month through the Payout Period is discounted to the Retirement Date using 144 payments (12 years x 12 per year) at 6.5%. The resulting figure is then discounted through the Deferral Period to the Divorce Date using a period of 19 years at 6.5% to arrive at a present value of \$20,513. The plan is non-contributory, so \$20,513 is used as the figure to multiply by 66.7% (10 / 15) to extract the marital value of \$13,682. This value now sits on Mr. Smith's marital balance sheet as an asset of his to be offset with other assets that his wife will receive.

Using the Deferred Distribution Method To Value An Interest In A Defined Benefit Pension Plan (Unvested Benefits)

The deferred distribution method, by definition, delays the determination of the amount the ex-spouse will receive in the divorce. Per *Cohen*, "the court may determine the formula for dividing the monthly benefit at the time of the decree, but delay the actual distribution until the benefits become payable." Thus, no actual present value or single, lump-sum figure is calculated, rather a percentage of the monthly benefit, once drawn, is to be paid to the ex-spouse. The variables used to determine the percentage should be those in effect at the time of divorce.

This method is best illustrated with an example. Mr. Smith, age 47, who has worked for the ABC Widget Company for 17 years (since age 30), is divorcing his wife of 10 years. He is not vested in the pension plan and will not be until age 50 when he has completed 20 years of service. No estimate is given or available as to the expected monthly benefit upon retirement. The pension is not valued at date of divorce, but the pension is a valuable asset of the marriage. According to *Cohen*, a deferred distribution could be ordered that provided for a percentage of the pension to go to Mrs. Smith, if and when paid to Mr. Smith.

The ratio for unvested pensions is slightly different than that used to figure the vested pension that accrued during the marriage. Under *Cohen*, an unvested pension is calculated using the ratio of the years of the marriage to the years of the vesting period required in the plan. In this example, the percentage of the pension subject to marital property division is 50% (10 year marriage / 20 year vesting). The court would then decide as to what percentage of the 50% Mrs. Smith would receive once Mr. Smith began drawing.

Conclusion

The Tennessee courts have decided many times over that vested and unvested pension benefits are subject to equitable division in a divorce. The courts have even set forth prescribed methods to execute the valuation or division of the benefits. The present value and deferred distribution methods are specifically mentioned in *Cohen* and several other cases as acceptable and understandable procedures for valuation. Other, more complicated methods are available, with some considered more accurate than those described in this article, however, the bottom line is that the value or percentage derived must be reasonable and explainable to the court.