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# Weighing the Values of Pensions as Marital Assets: Some Potential Pitfalls

by Allan M. Feldman\*

In *Stevenson v. Stevenson*, 511 A 2d 961 (RI 1986), the Rhode Island Supreme Court surveyed the law and scholarly literature on whether or not pensions should be viewed as marital property subject to equitable distribution. The Court found "nearly unanimous support for the proposition that pension funds are marital property" (p. 964). It decided that "a pension is reasonably analogous in form to a forced savings account whose funds will become available to the parties upon retirements" (p. 965). Therefore a pension should be placed on the scale and weighed along with other marital assets when those assets are divided in a divorce.

The purpose of this note is to make some observations about how the pension ought to be weighed. How should a court figure the present value of promised income that may start 10, 20 or 30 years in the future? Unfortunately the technique for weighing the pension was not an issue in the Supreme Court's *Stevenson* decision. In that case a trial justice had rejected an actuary's testimony regarding the value of the pension and had figured the value himself, based on the pension formula. The example below, however, shows that there are serious pitfalls in calculating pension values, pitfalls that must be avoided if a property division is to be truly equitable.

As was the case of *Stevenson*, a husband is often covered under a pension plan at his place of employment while his wife is not. John Doe's pension plan is a valuable and important asset and Jane Doe naturally wants it included in the marital estate, along with other assets like the family house, car, and savings account.

When the pension plan is a defined contribution plan, its current value is normally easy to determine. The plan administrator should know the total amount of contributions that have been made and the accumulated investment income on those contributions. When the pension plan is a

defined benefit plan, however, its current value is not so obvious. Typically there is a formula for determining what John Doe's monthly pension check will be based on two crucial variables: The number of years of credited service (N) and the wage John receives (W). Very often W is defined as the average of the three or five years' highest pay, which, since wages tend to go up year by year, means W is the average of the most recent several years' pay.

In valuing John Doe's pension plan, the court wants a determination as of the date of dissolution of the marriage. This implies that N in the formula should be John's accumulated service to date, rather than to the time of his planned retirement. Taking N to date makes perfectly good sense, since any future year's credited service will be accrued after the marriage has been dissolved. Jane Doe should have no claim on John's future compensation, at least insofar as the division of the present marital estate is concerned.

Enter pension evaluation pitfall number 1. Although it looks as reasonable as taking N to date, taking W as of the date of dissolution may be most unreasonable. The reason is that so doing ignores inflation. Even if John Doe never earns a promotion between the time of his divorce and the time of his retirement, even if he never gets a genuine raise in terms of purchasing power, inflation alone will cause his pay to go up. Therefore, if he remains with his employer, his high three or high five W will go up, and the pension to which he is entitled will rise above and beyond any increases due to a higher N.

A numerical example will help make the point. Suppose Mr. and Mrs. Doe divorce at his age 45, and we assume that he is to retire and start collecting a pension 20 years later, at age 65. We shall also assume that John has been with his employer for 15 years, and that, based on his years of service to date and his current high three W of \$25,000 per year, he would

be entitled to a pension of \$500 per month. We shall further assume that, based on his life expectancy, John will live for 10 years after he retires.

Finally, we might use a discount rate to calculate present values of 8.5 percent (slightly less than the yield on long-term U.S. Treasury bonds as this is written), and project an average inflation rate over the next 20 years of 6.0 percent (slightly less than it has averaged over the last 20 years).

Using these assumptions then, based on John's current years of service, or N = 15, and his current W of \$25,000, the present value of accumulated pension rights would be only \$8,356. However, if John remains employed but only gets raises to cover inflation (so that his pay in real purchasing power terms remains constant), W will rise to \$80,178 in 20 years. When the revised W is inserted in the pension formula, the monthly pension becomes \$1,604, *even if the additional 20 years of service are ignored*. Based on the corrected W, the present value of accumulated pension rights is \$26,805, rather than \$8,356. The table below shows how the present value of lifetime pension rights depends on N and W. (It is assumed here that the monthly pension is directly proportional to years of credited service.)

**Present Value of John Doe's Pension Rights**

	W = \$25,000	W = \$80,178
N = 15	\$8,356	\$26,805
N = 35	\$19,497	\$62,545

In an attempt to be fair to Mr. Doe a court might weigh the value of this asset at \$8,356. After all, Mr. Doe might leave his employ right after the divorce, and if he does, the ultimate W will be only \$25,000. But it is more

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likely that Mr. Doe will not abandon a 15-year career. And assuming that Mr. Doe remains employed but gets no real raises, the value of the first 15 years service should be \$26,805, not \$8,356. To weigh its value at \$8,356 is most unfair to Mrs. Doe. (Of course, it would be equally wrong to value the asset at \$62,545, based on 35 years of service, since the difference between \$62,545 and \$26,805 is attributable to 20 years of work subsequent to the divorce.)

Pitfall number 1 suggests that ignoring inflation may result in the pension being undervalued at \$8,356, rather than properly valued at \$26,805. Concerned about the complexities of inflation assumptions and discounting methods, a court might be tempted to use the total offset approach — according to which the inflation rate and the discount rate cancel each other out. However, this is pitfall number 2.

Based on the total offset approach, John Doe's pension is worth \$500 per month times 120 (i.e., 10 years' worth of months), or \$60,000. This grossly overvalues the pension. Firstly, Mr. Doe's pension fund does not view his actuaries as a \$60,000 liability; its actuaries and economists know that

6 percent (the assumed rate of future inflation) is not equal to 8.5 percent (the applicable discount rate). Secondly, Mr. Doe could go to an insurance company and buy an annuity that would pay \$1,604 per month, starting in 20 years and continuing through his life expectancy, for much less than \$60,000. In fact, the insurance company would charge around \$26,805, plus sales and administrative charges.

Pitfall number 3 has to do with indexation of the pension payment itself, rather than indexation of W. Private pension plans typically provide for flat pensions: The monthly check is the same at age 75 as at age 65. However, some public pension plans, including those for most Rhode Island government employees, provide for pension escalators. If John Doe's pension were to grow at 6 percent per year based on an automatic escalator, then its properly calculated present value as of the dissolution of the marriage is not \$26,805, but \$35,754.

Pitfall number 4 is this: Jane Doe, if average, would outlive John Doe by five to ten years. If they remained married and he predeceased her, she would likely receive a spousal survivor pension equal to some substantial fraction of John's retirement pension.

She loses this right through the divorce. Yet a court may overlook a spousal survivor pension in weighing the marital assets. If John marries a second wife, say Jean Doe, the benefits live on, and Jane Doe never receives compensation for her loss of it.

To summarize, a court must be wary in weighing the value of a pension. The commonest formula for a defined benefit plan hinges on the high three or high five pay. The first hazard in valuing the pension is ignoring the likely effect of inflation on that pay. This undervalues the pension and results in an inequitable outcome for the spouse without the pension. The second hazard is the use of the total offset method. This overvalues the pension and is unfair to the spouse with it. The third hazard is ignoring cost-of-living adjustments in the pension itself and the fourth is ignoring possible spousal survivor pensions; both of these hazards may lead to undervaluations of the pension, and are therefore unfair to the spouse without it.

A divorce is of course an adversarial proceeding, in which each party may present evidence as to the value of marital assets, including the pension. In this proceeding the husband's expert may place a very different value on the pension than the wife's expert. Most likely both experts are doing the arithmetic correctly; their differences arise from different assumptions. The role of the court is to discover these assumptions, to discard the improbable ones and retain the probable, and to find the value of the asset based on probable assumptions. If the court does this, it will avoid the four pitfalls outlined above.

*I am grateful to Attorneys William Chaika, Al Factor and Ralph Ryan for comments on a draft of this paper. All remaining errors are, of course, my own.*

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