QDRO benefit calculations: A closer look at early retirement subsidies

Esther Peterson, ASA, MAAA
Yaturo Seki, FSA, EA, MAAA

Introduction

The purpose of this article is to provide methods for calculating benefits payable under a separate interest Qualified Domestic Relations Order (QDRO) when a pension plan offers subsidized early retirement.

A QDRO is a court order that assigns a portion of a participant's benefit to an alternate payee (AP). An AP can be a spouse, former spouse, child, or other dependent of the participant.

In general, there are two categories of QDROs, shared payment and separate interest.

- In a shared payment arrangement, the participant's actual benefit payments are divided between the participant and the AP. Generally, shared payment QDROs are used only after a participant is already in pay status. Therefore, it is irrelevant whether an early retirement subsidy is involved. The benefit is calculated as if there were no QDRO, and the specified portion of the participant's payment is paid to the AP.
- In a separate interest arrangement, a portion of the participant's retirement benefit is assigned to the AP and is payable based on the AP's lifetime. The AP may choose to commence benefits at a different time and in a different form of payment than the participant. In contrast to a shared payment, the calculations involved in separate interest QDROs can be complicated, especially if the plan offers subsidies.

The focus of this article is separate interest arrangements.

Separate interest QDROs

The applicable provisions of the Internal Revenue Code provide that a QDRO be drafted in a way that it "does not require the plan to provide increased benefits (determined on the basis of actuarial value)."1 Therefore, benefits payable to an AP under a separate interest QDRO should be adjusted for the difference in life expectancy between the participant and the AP. For example, a benefit of $1,000 per month payable to a 65-year-old participant does not have the same actuarial value as $1,000 per month payable to a 55-year-old spouse because the spouse is expected to live longer and receive more payments. To have the same actuarial value, the benefit payable to the spouse would have to be reduced.

If the pension plan offers subsidized early retirement, then the value of the subsidy may need to be taken into consideration when determining benefits under a QDRO. In our experience, QDROs either explicitly award the AP a pro-rata share of the early retirement subsidy or are silent on the issue. If the QDRO is silent, one should refer to the plan document, the plan's QDRO procedures, and/or fund counsel for guidance. It should not simply be assumed that the AP is not entitled to a portion of the early retirement subsidy.

Although opinions may differ by practitioner, we believe the early retirement subsidy exists only if the participant commences early retirement benefits and receives the subsidy. If the AP commences benefits before the participant, then the AP's benefit will not reflect an early retirement subsidy. Providing the AP with an early retirement subsidy before the participant retires may violate the aforementioned rule against paying increased benefits. If the QDRO awards the AP the subsidy and the participant subsequently commences benefits and receives the subsidy, then the AP's benefit should be recalculated and increased prospectively to reflect the subsidy.

Finally, if the participant retires on or after normal retirement date (NRD), then there is no early retirement subsidy that must be considered in the calculations.

Basics of separate interest QDRO calculations

The basic calculation steps for a separate interest QDRO are as follows:

FOR THE AP:

1. Determine the amount of participant's accrued benefit assigned to the AP based on the terms of the QDRO. We will refer to this as the "AP Offset."
2. Calculate the present value (PV) of the AP Offset.
3. Convert the result in step 2 to an annuity payable to the AP.

FOR THE PARTICIPANT:

1. Calculate the PV of the participant's total accrued benefit without regard to the AP Offset.
2. Subtract the PV of the AP Offset (step 2 from AP's calculation) from the result in step 1.
3. Convert the result in step 2 to an annuity payable to the participant.

We will now consider how to calculate benefits under the following scenarios:

- The AP is not entitled to early retirement subsidies.
- The AP is entitled to early retirement subsidies, and
  - Participant and AP commence benefits at same time.
  - Participant commences benefits before AP.
  - Participant commences benefits after AP.

For these scenarios, we have assumed that the participant retires with an early retirement subsidy, the normal form of payment is a single life annuity, and the plan does not offer a lump-sum option.

AP not entitled to early retirement subsidies

When the AP is not entitled to early retirement subsidies, the steps to determine the amount payable to the AP are the same as steps 1, 2, and 3 outlined in the previous section.

(a) Determine AP Offset based on the terms of the applicable QDRO.

(b) Calculate PV of AP Offset using participant's age and mortality at AP's Date of Commencement (DOC). This is the product of AP Offset and the participant's deferred annuity factor from AP's DOC to NRD.

PVAP Offset @ AP's DOC = AP Offset x (Participant's deferred annuity factor from AP's DOC to NRD)

(c) Convert PV of AP Offset to annuity based on AP's age and mortality by dividing the result from (b) by the AP's immediate annuity factor at the AP's DOC.

Amount payable to AP = PVAP Offset @ AP's DOC ÷ (AP's immediate annuity factor at AP's DOC)

The amount payable to the participant should include the value of the early retirement subsidy not awarded to the AP.

(a) Determine PV of participant's early retirement benefit (ERB) without regard to the AP Offset. This is the product of the participant's ERB and the participant's immediate annuity factor at participant's DOC.

PVParticipant's ERB = ERB x (Participant's immediate annuity factor at participant's DOC)

(b) Determine PV of AP Offset at participant's DOC. This is the product of the AP Offset and the participant's deferred annuity factor.

PVAP Offset @ Participant's DOC = AP Offset x (Participant's deferred annuity factor from participant's DOC to NRD)

Note that if the participant's DOC is the same as the AP's DOC, then this present value will equal the present value calculated in step (b) above for the AP. However, if the participant commences benefit payments after the AP's DOC, these two present values will not be the same.

(c) Convert the PV of participant's ERB after AP Offset to an annuity based on participant's age and mortality. This conversion is completed by subtracting the result in (b) from (a), and then dividing the difference by the participant's immediate annuity factor at ERB. This leaves the entire value of the early retirement subsidy with the participant.

Amount payable to participant = (PVParticipant's ERB – PVAP Offset @ Participant's DOC) ÷ (Participant's immediate annuity factor at participant's DOC)

AP entitled to early retirement subsidies

When an AP is entitled to early retirement subsidies, the benefit payable to the participant can be calculated as follows:

(a) Determine AP Offset based on terms of the applicable QDRO.

(b) Take the difference between the participant's total accrued benefit and AP Offset, and then multiply the result by the applicable early retirement factor (ERF).

Amount payable to participant = (Total accrued benefit – AP Offset) x ERF

In contrast, the benefit payable to the AP will depend on the AP's commencement date relative to that of the participant.

1. PARTICIPANT AND AP COMMENCE BENEFIT PAYMENTS ON THE SAME DATE

(a) Determine AP Offset based on terms of the applicable QDRO.

(b) Determine PV of AP Offset at participant's DOC. This is the product of the AP Offset, the participant's immediate annuity factor at participant's DOC, and the applicable ERF.

PVAP Offset @ Participant's DOC = AP Offset x (Participant's immediate annuity factor at participant's DOC) x ERFParticipant's DOC

(c) Convert PV of AP Offset at participant's DOC to annuity based on AP's age and mortality. This conversion is completed by dividing the result from (b) by the AP's immediate annuity factor at participant's DOC.

Amount payable to AP = PVAP Offset @ Participant's DOC ÷ (AP's immediate annuity factor at participant's DOC)

2. PARTICIPANT COMMENCES BENEFITS BEFORE AP

The steps are the same as in #1, except that the immediate annuity factor in step (c) is a deferred annuity factor from participant's DOC to AP's DOC.

(a) Determine AP Offset based on terms of the applicable QDRO.

(b) Determine PV of AP Offset at participant's DOC. This is the product of the AP Offset, the participant's immediate annuity factor at participant's DOC, and the applicable ERF.

PVAP Offset @ Participant's DOC = AP Offset x (Participant's immediate annuity factor at participant's DOC) x ERFParticipant's DOC

(c) Convert PV of AP Offset at participant's DOC to annuity based on AP's age and mortality at AP's DOC. This conversion is completed by dividing the result from (b) by the AP's deferred annuity factor from the participant's DOC to the AP's DOC.

Amount payable to AP = PVAP Offset @ Participant's DOC ÷ (AP's deferred annuity factor from participant's DOC to AP's DOC)

3. AP COMMENCES BENEFITS BEFORE PARTICIPANT

The benefit payable to the AP while the participant is not in payment status is the same as the scenario where the AP is not entitled to early retirement subsidies. Once the participant commences receiving a subsidized early retirement benefit, the AP's benefit should be increased to reflect the subsidy.

Increase to benefit payable to AP beginning on participant's DOC.

(a) Determine PV of AP Offset at participant's DOC.

PVAP Offset @ Participant's DOC = AP Offset x (Participant's immediate annuity factor at participant's DOC) x ERFParticipant's DOC

(b) Determine PV of AP Offset at participant's NRD.

PVAP Offset @ NRD = AP Offset x (Participant's deferred annuity factor from participant's DOC to NRD)

(c) Determine PV of AP's Early Retirement Subsidy. This is calculated as the difference between the result in (a) and (b).

PVAP ER Subsidy = PVAP Offset @ Participant's DOC - PVAP Offset @ NRD

(d) Convert PV of AP's Early Retirement Subsidy to annuity based on AP's age and mortality at participant's DOC. This conversion is completed by dividing the result from (c) by the AP's immediate annuity factor at participant's DOC.

Increase to AP's benefit = PVAP ER Subsidy ÷ (AP's immediate annuity factor at participant's DOC)

(e) Add result in (d) to the AP's current benefit.

The increase in the AP's benefit at the participant's DOC is only effective prospectively.

Summary

When calculating the benefits payable to a participant or AP under a QDRO, early retirement subsidies present unique calculation challenges. The benefits determined under a QDRO must not constitute an increase in plan costs. Special attention needs to be given to QDROs when the AP commences benefits prior to the participant because of the potential eligibility for an early retirement subsidy benefit increase. QDROs come in all shapes, sizes, and levels of complexity, and early retirement subsidies along with relative dates of commencement play key roles in determining benefit amounts.

CONTACT

Esther Peterson
esther.peterson@milliman.com

Yaturo Seki
yaturo.seki@milliman.com