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By Greg Gann

How a Pension Valuation Can Be Used to Negotiate a Marital Settlement Agreement

Marital Assets

Home worth $500,000. No mortgage. Husband's 401k worth $750,000. Wife's 403b worth $150,000. Non-retirement investments also worth $120,000. Husband and Wife each have defined benefit pension plans.

Income

Husband earns $110,000. Wife earns $80,000.

Wife's Proposal

Divorce is initiated by Wife. She seeks no alimony. She establishes that she must retain ownership of the home ($500,000 asset) and that she will offset this $500,000 amount from Husband's 401k of $750,000 leaving $250,000 that she says should be split in half thereby asserting her claim to $125,000 of his 401k. She also says her 403b amount of $150,000 should be split in half or $75,000 to each, and proposes to subtract this $75,000 from the $125,000 that she is "owed" from his 401k. She also says that she will retain her pension and Husband will retain his pension.

Reality Derived from Valuations

The cost basis in the home is $260,000. Therefore, if Wife retains ownership exclusively, her net equity will be below the $250,000 taxable exclusion, making the house a tax-free asset for her. In contrast, his 401k and her 403b are subject to full income tax rates. Conservatively, we attributed a 25% tax rate to each, resulting in a net value of $563,000 and $113,000 for his 401k and her 403b respectively. Analyzing the tax ramifications for the different assets punctured a hole in Wife's proposal. With the tax analysis overlay, the home equity and the value of Husband's 401k were almost the same. She quickly backed down from asserting rights to his 401k.

The other part of the analysis that punctured Wife's proposal emerged from getting more data on each pension plan. From each spouse's plan administrator, we learned that in 8 years, she is eligible for full retirement pension benefits of $3340/month, and that he was eligible for $2200/month in that same year. Not only are the monthly distribution amounts not equivalent, but additionally the life expectancy and mortality rates are very different based on their ages and gender. In fact, the net present value of her pension came to almost $800,000 where his came to about $400,000.

Outcome

Although the parties were initially diametrically opposed, and Husband felt that Wife's proposal would have taken him to the cleaners, as a result of the financial analysis, Husband will not have to share any of his 401k, and other than a small stipend as an emergency cash cushion for Wife, Husband will receive all non-retirement investments. Each will retain his and her pension, and Wife will retain the house. Agreement was reached because now Husband has adequate cash to make a down payment on a home for himself. Under Wife's proposal, he would have had to not only turn over some of his 401k to her, but he would have also had to have borrowed from the 401k in order to make a down payment.

Moral of the Story

Although Wife's proposal on its face seemed very logical and reasonable, exposing the implications of both the latent tax and pension valuations that were unknown to the parties facilitated compromise and negotiation and a shift in the power play where each side got enough of what was important to him and her to settle. Imagine how Husband or Husband's counsel would have felt had they failed to identify the rationale for such valuations and their ultimate impact on the terms of the marital settlement agreement.