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What is the danger of offsetting pension and 401(k) benefits?

Pension and 401(k) plans have very different characteristics, including valuation methods, funding and investment risks, and distribution options. Even retirement plans of the same type very rarely have the exact same features and risks.

To illustrate this let's assume a divorcing couple, Tom and Nancy, are both age 45. Tom has worked 25 years and has a pension benefit of $2,200 per month at age 65, the present value of which is $245,000. Nancy has a 401(k) balance of $245,000. Each party wants to keep his/her own plan in exchange for his/her share in the other party's plan. After all, both assets have the same value. However, before counseling your client about this matter, consider the following:

Pension Valuation Risks (e.g., Early Retirement Incentives)

Calculating the present value of a pension benefit is complicated and takes into account several actuarial factors. However, the present value may not include a benefit enhancer that vests after divorce, like an early retirement subsidy, but that is based largely on marital service.

In our example, let's further assume Tom's plan has an early retirement subsidy that allows him to retire with full benefits after 30 years of service. In this case, the value of Tom's pension just 5 years in the future, at age 50, is about $600,000. Nancy would have to achieve an almost 20% rate of return over those 5 years for her 401(k) to be worth a similar amount.

Pension Funding and Investment Risks

Generally, a pension plan sponsor cannot reduce a person's previously earned benefits, and must sufficiently fund the plan to make promised benefit payments. As a result, the plan sponsor typically assumes both the funding and investment risks. However, if the sponsor does not have the assets to fund the plan, or if the plan's investments underperform, a participant may not receive all the benefits he/she earned. Although the PBGC guarantees most private employer pensions against bankruptcy, its guarantee has limits. Union plans, many of which are severely underfunded, may be able to reduce previously accrued benefits. Also, several state governments are considering cutting pension benefits to deal with budget shortfalls.

401(k) Funding and Investment Risks

Whereas a pension promises a certain amount of benefits at retirement, a person's 401(k) benefit at retirement depends entirely on the amount he/she contributes to the plan (plus employer contributions, if applicable) and investment performance. As a result, although a 401(k) account balance may be equal to the present value of pension benefits at divorce, that balance may be materially less or greater than the pension value at retirement.

The Only Way to Equally Share Risks/Rewards

There may be legitimate reasons, beyond the scope of this article, to offset retirement assets. However, the only way to accurately equalize the parties' retirement assets, including sharing risks and other plan features, is to divide each plan with a QDRO.