TRISTAR PENSION CONSULTING

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Don’t let the QDRO be Worse than the Marriage

- **Introduction**
- **What is a QDRO**
- **Requirements**
  - **Identification of the Parties**
  - **Description of Benefits**
  - **Purpose and Direction of Payment**
- **Prohibitions**
  - **Inconsistency with Plan Provisions**
  - **Amount of Benefits**
  - **Conflict with Previous QDRO**
- **Processing**
- **Don't Make Assumptions**
- **Death and Taxes**
  - **Taxes**
  - **Death**
- **Summary**

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Very few employers have any desire to get caught in the middle of the divorce proceedings of their employees; however, when company retirement benefits become part of the negotiations, unsuspecting employers can be pulled into the fray.

One of the foundational rules for qualified retirement plans is that participants' benefits cannot be pledged as collateral or assigned to another party. Conditioning the plan's tax-favored status on this prohibition helps to protect participant benefits; however, there are a small number of exceptions to this rule.

One such exception is that benefits can be included in marital property and assigned to a former spouse as part of domestic relations proceedings. This is accomplished via a Qualified Domestic Relations Order or QDRO.

WHAT IS A QDRO?

As the name suggests, a QDRO is a court order issued pursuant to state domestic relations laws (Domestic Relations Order or DRO) that is used to assign company provided benefits to an alternate payee, typically as part of divorce or marital separation proceedings. Although the rules governing QDROs are relatively straightforward, many divorce attorneys tasked with drafting them are unfamiliar with the nuances of qualified retirement plans. That can make an otherwise simple situation very complicated very quickly...and when dealing with the emotionally charged setting of a divorce, complication can lead to unpleasantness.

REQUIREMENTS

There are several key elements that must be included in a domestic relations order for it to be considered a QDRO.

IDENTIFICATION OF THE PARTIES

The order must identify the plan, participant and the alternate payee, i.e., the party receiving benefits. This requirement is usually, but not always, easily satisfied. For example, an order that identifies the plan as the ABC Company's retirement plan may be sufficient if ABC Company has only sponsored a single retirement plan. However, if ABC has both a 401(k) plan and a cash balance plan, the order would be too vague without specifically naming the plan to which it referred.

Data privacy concerns have led many to discontinue including social security numbers as a means of identifying the participant and alternate payee, so there must be sufficient information included to ensure proper identification of all parties. This may be an easy task in most cases, but further detail may be needed if a participant's name is John Smith.

DESCRIPTION OF BENEFITS

The order must clearly articulate the amount of benefits to be paid or a formula for determining the benefits. For example, an order may require a participant to pay a former spouse $50,000. Alternatively, it may describe the benefit as 50% of the vested account balance as of a specified date. These two may be combined to ensure a minimum or maximum level of benefits, e.g., 50% of the vested account balance as of January 1, 2011, subject to a minimum amount of $50,000.

Then, there is the question of investment performance. If there is a lag between the determination date (January 1, 2011 in the above example) and the date the benefits are actually paid, the order should specify if the alternate payee is to share in any investment gains or losses during the interim.

PURPOSE AND DIRECTION OF PAYMENT

A QDRO must provide child support, alimony or other marital property rights. Although the alternate payee is typically a spouse, former spouse, child or other dependent, benefits can be payable to another entity for the benefit of one of these parties. For example, the order may direct payment to a state department of family services to provide benefits for a participant's child.

PROHIBITIONS

Just as some items are required, other provisions will disqualify an order.

INCONSISTENCY WITH PLAN PROVISIONS

An order is not permitted to provide a type or a form of benefit or a benefit option the plan does not otherwise provide. For example, if a plan does not allow distribution in the form of an annuity, a DRO related to that plan cannot be qualified if it requires an annuity.

AMOUNT OF BENEFITS

An order cannot provide benefits greater than the benefits available to the participant without the QDRO. For example, if a participant's account balance is $45,000, a DRO assigning benefits equal to $50,000 cannot be qualified. That is why many orders describe the amount payable as a percentage of the participant's benefits rather than as a flat dollar amount, especially in light of the economic volatility experienced over the last several years.

CONFLICT WITH PREVIOUS QDRO

In the event a previous QDRO has assigned benefits to an alternate payee, a subsequent DRO cannot assign those same benefits to a different alternate payee. During 2010, the Department of Labor published new regulations clarifying this issue. The regulations specify that receipt of a DRO after an event such as a death or divorce or after receipt of another QDRO does not necessarily mean there is a conflict. Rather, the substance of the order(s) must be considered.

As long as payments under the first QDRO have not already commenced, a subsequent order modifying the amount is not, per se, a conflict. Similarly, if a participant who is already subject to one QDRO becomes subject to another, there is no conflict as long as the subsequent order does not attempt to assign the same benefits addressed in the first order.

PROCESSING

All plans are required to have procedures that describe how DROs will be processed and reviewed to determine their qualified status. Among other things, the procedure should specify the timing within which the review will take place and outline the flow of communication among the parties.

On receipt of an order, the plan sponsor should take immediate steps to freeze loans and distributions of the participant's benefits during the review period. The freeze should generally remain in effect until the earlier of:

- 18 months from the date the benefit was frozen;
- The date distribution is made to the alternate payee;
- The date the plan sponsor receives a court order releasing the participant's benefit from the freeze; or
- At the end of the 30-day appeal period that begins upon the alternate payee's notification the DRO has been denied if no appeal is filed.

DON'T MAKE ASSUMPTIONS

While the rules described in this article are not necessarily complicated, the facts and circumstances of each situation bring unique details to be considered. As a result, each proposed QDRO should be reviewed carefully. Whether it is identification of the plan from which benefits will be paid or the calculation of the benefit itself or anything in between, any confusion should be clarified with the attorneys representing the parties.

It may be tempting to make assumptions in the interest of expedited processing; however, if those assumptions are incorrect and lead to improper payment of benefits, the plan sponsor may be held liable to make the parties whole. Although divorcing spouses are typically on opposite sides of the negotiation, they can unite very quickly against an employer who has incorrectly processed a QDRO.

DEATH AND TAXES

As the saying goes, death and taxes are both unavoidable, and the same is true with QDROs.

TAXES

When an ex-spouse receives distribution of plan benefits pursuant to a QDRO, he or she is responsible to pay the associated income tax. While this may seem obvious, both parties do not always understand that fact. Sometimes, however, the parties do understand and try to renegotiate the tax liability.

There was a Tax Court case in 1996 that dealt with this very issue. The QDRO in that case was written to shift the tax liability from the alternate payee (the ex-spouse) to the participant, but the Court held that the terms of a QDRO cannot override federal tax law and required the ex-spouse to pay the associated taxes. This does not mean that the parties cannot negotiate the principal amount of the QDRO payment to "gross-up" the alternate payee for the anticipated tax liability.

Distributions made pursuant to QDROs are generally taxed in the same manner as any other "typical" plan distribution (other than hardship distributions or required minimum distributions). The alternate payee has the option to receive payment in any form permitted by the plan, e.g., lump sum, installment, etc. He or she also has the option to take the payment as a cash-out or rollover into an IRA or another qualified plan. One key difference is that alternate payees who elect

a cash-out distribution are not subject to the 10% early withdrawal penalty if the distribution is taken directly from the plan.

DEATH

The potential for QDRO-related confusion does not always stop when payment has been made. It is not uncommon for a participant to assume that a QDRO officially concludes any right that his or her former spouse may have to retirement benefits. However, an ex-spouse may be listed as the participant's beneficiary. The federal courts see a number of cases each year involving "unintended" payment of death benefits. The typical scenario goes something like this...

A participant and second spouse go through a divorce, and the second spouse receives half of the participant's retirement benefits via QDRO. Fast-forward a few years to the participant's death. The participant has a will leaving all remaining assets to his or her children from the first marriage. However, the most recent plan beneficiary designation on file lists the second spouse as the primary beneficiary, because the participant forgot to file a new designation following the second divorce.

Since a beneficiary designation is considered a plan document, the sponsor follows the form on file and pays all remaining retirement benefits to the now-former second spouse. The children from the first marriage file suit, naming the second spouse and the plan sponsor.

While the facts of each case are unique, the plan sponsor in this fact pattern is generally correct in paying benefits to the person named on the most recent beneficiary designation form. The participant's will may determine how assets outside the plan are paid but it has no bearing on the payment of plan benefits. As a result, it is recommended as part of the QDRO procedure that plan sponsors remind participants to update their beneficiary designations.

SUMMARY

Divorces can be messy, and financial negotiations can make an already heated situation reach a boiling point. Understanding the rules of engagement and clearly documenting procedures can keep the plan sponsor's role to one of "just business" and minimize the liability associated with being pulled into the middle of an emotionally charged situation.

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