DIVIDING RETIREMENT BENEFITS: QDRO BASICS FOR FINANCIAL PROFESSIONALS

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Although retirement assets are often the most substantial part of a marital estate, there is a surprising lack of knowledge about how to divide such assets among divorcing parties and their lawyers, as well as financial analysts and planners. This is one area of divorce practice where it is especially easy to make mistakes – and those errors often cannot be fixed once they are discovered.

Most financial professionals are aware that qualified retirement plans can be divided between divorcing parties by Qualified Domestic Relations Order ("QDRO"), as set forth under Employee Retirement Income Security Act ("ERISA") and Section 414(p) of the Internal Revenue Code. Congress decided, in the late 1970s and early 1980s, that qualified retirement plans should be required to permit the "spouse, former spouse, child, or other dependent" of an employee to receive a portion of the employee's retirement benefits, if the court in a state domestic relations action ordered such benefits to be paid to an appropriate "Alternate Payee" as described under the statute.

As a result of ERISA, the division of retirement assets in divorce cases has become commonplace; the benefits earned by an employee spouse under both defined contribution and defined benefit plans are regularly allocated between divorcing parties such that the non-employee spouse is able to receive a share of the benefits as alimony, child support, or the division of marital property. QDROs are most often used to divide marital property between spouses in divorce cases, but they can also be used in post-divorce actions to provide a source of payment for overdue support obligations, and they can be employed to provide funds to anyone involved in any type of domestic relations action who meets the criteria under the statute to be considered an Alternate Payee (again, this includes a "spouse, former spouse, child, or other dependent" of the Participant).

In most jurisdictions, the majority of divorce cases today are settled by agreement of the parties, without a final trial in front of a judge. This means that the division of most retirement assets is negotiated between the parties and set forth in a Settlement Agreement, which becomes incorporated into the divorce decree when the final divorce is granted by the judge. Usually, the QDRO process is not initiated until after the divorce is final, although there are variations in this practice. The reality of the divorce process in most cases is that the negotiations frequently take place without full information about the retirement plans, and this lack of information can lead to difficulties after the divorce, when the parties attempt to effectuate the division of retirement assets set forth in their divorce decree or agreement. To protect their clients, divorce financial professionals should be aware of some of the basic concepts of retirement plans and the most common errors made in this area during the divorce process.

I find that even experienced divorce professionals do not always know or understand the crucial differences between various types of retirement plans, so we will start with a quick review of these issues and then examine how these differences can play out in a divorce.

I. KEY DIFFERENCES BETWEEN QUALIFIED RETIREMENT BENEFIT PLANS

A) Defined Contribution Plan

The most common example of a **defined contribution plan** is a 401(k) plan. In a defined contribution plan, the employee can make pre-tax contributions into an account maintained in his or her own name. The employer can also make contributions of a fixed percentage of the employee's salary into the account. In a defined contribution plan, there is no guarantee as to how much money will be in the account when the employee retires. That depends on the performance of the investments in the account over time. The only thing that is guaranteed, or "**defined**," is the amount that the employer **contributes** periodically to the employee's account.

B) Defined Benefit Plan

By contrast, in a **defined benefit plan**, there is no specific account maintained separately for a particular employee; there is a trust fund for all employees who participate in the plan. As employees accumulate years of service to an employer, they accumulate credit toward their retirement benefits. A traditional pension plan is the most common type of defined benefit plan, in which employees know that if they work for Titanic Corporation for thirty years, they will receive a monthly benefit of a certain dollar amount for the rest of their lives after retirement. Thus, the amount of **benefit** that they will receive is **defined** (unlike in a defined contribution plan). That is, an employee is guaranteed (after working long enough for the benefits to "vest") a certain benefit based on the employee's length of service and salary at the time of retirement.

It is important to understand the difference between these two types of plans. Often, in divorce negotiations, attorneys and parties refer simply to the "retirement plan," but they don't investigate which type of plan the employee really has. Someone who participates in a defined contribution plan normally receives periodic statements showing the exact balance in the account. It is relatively simple to divide a defined contribution plan in a divorce, because the precise value of the account is usually easy to determine. It is generally more complicated to divide a defined benefit plan, because the value of the benefit at any given time can only be determined based on actuarial calculations and assumptions regarding when the employee will retire or leave the company and what his salary will be at that time.

C) Cash Balance Plan

There is another type of retirement plan that often causes confusion in divorce cases. **Cash balance** plans are a hybrid of defined contribution and defined benefit plans. They have become increasingly popular with employers. Cash balance plans are technically defined benefit

plans, with many features similar to defined contribution plans. The value of a cash balance plan is usually expressed in statements as a "cash balance" – that is, they look a lot like defined contribution plans, because they show a precise dollar amount in an "account" for a particular employee. Many divorce practitioners treat cash balance plans just like defined contribution plans for purposes of settlement, only to find that cash balance plans are not as easily divided as defined contribution plans. In fact, many employees do not realize that their cash balance benefits are not the same as those in a 401(k) plan. Cash balance plans are usually not subject to market fluctuations. Instead, participants earn "interest credits" over time. Cash balance plans seem to be the most common form of hybrid plan, but there are also other types of "hybrid" plans that have their own quirks. The universe of possibilities for hybrid plans seems to be expanding all the time.

The distinction between the types of plans in the marital estate is important because you need to know what you are really dividing. Is it the right to receive monthly payments in the future, or a portion of an account with an identifiable balance that is fluctuating over time? The relevance of various issues, such as earnings and losses, surviving spouse benefits, and cost of living increases depends on the type of plan being divided. It is surprising how often divorce settlement agreements contain statements such as, "Wife shall receive one half of Husband's Pension Plan as of the date of the divorce, plus or minus earnings and losses from that date until the date the account is divided." This presents a problem, since the concept of "earnings and losses" does not apply to pension (defined benefit) plans. Defined benefit plan benefits do not fluctuate with the market, and thus there are no "earnings and losses." Drafting an agreement with the wrong language for the type of plan the parties intend to divide can have far-reaching consequences for your client.

II. NON-QUALIFIED PLANS

A) Corporate Plans

Another issue that often trips everyone up in divorce cases is that not all retirement plans are divisible by QDRO, or any other method. There are a lot of retirement assets out there which are "**non-qualified**;" they are not subject to ERISA and just *cannot* be divided in a divorce. Some corporations offer non-qualified retirement benefits to highly paid employees, which allows them to provide these employees with additional retirement benefits beyond those which the tax provisions of ERISA will permit. Non-qualified retirement plans are common for high-ranking employees, and they can almost never be divided or assigned to anyone other than the employee. In contrast with qualified benefits, non-qualified benefits are usually conditioned on future employment and are also not secured in the event of the employer's bankruptcy, and thus are not guaranteed. If the employer goes out of business, non-qualified benefits almost always disappear.

Non-qualified plans usually have terms in their names such as: "Supplemental," "SERP," "Non-qualified," and "Excess Benefit." Plans with these terms in their titles are usually **not** qualified and will **not** accept a QDRO. These plans normally contain "anti-alienation" provisions which specifically prevent them from making payments to anyone other than the employee, and thus there is no way for payments to be made directly to a former spouse, regardless of what any court orders the Plan Administrator to do. It is crucial to determine whether a retirement (or deferred compensation) plan can be divided **before** settlement negotiations are completed. One of the most difficult post-divorce situations to deal with is when the parties discover, after the final judgment (in some cases, several years after the divorce), that one of the retirement assets they have agreed to divide is simply not divisible or assignable. It is worth noting, however, that

a small, but growing, number of non-qualified retirement plans *will* accept a Domestic Relations Order (a "DRO," not a "QDRO") which provides for payments to be made directly to a former spouse, just as a qualified plan would.

If this issue is investigated during the divorce proceedings, and it is determined that the non-qualified plan is truly non-divisible, then a provision can be included in the settlement agreement that recognizes that the funds cannot be divided until the employee spouse actually receives payment from the non-qualified plan, and then will be paid to the former spouse "if, as, and when" received by the employee. Payments from non-qualified plans are usually made after retirement, because they are intended to operate as "golden handcuffs" which provide incentives for key employees to remain with the company until retirement. If the employee is many years from retirement at the time of divorce, several very tricky issues arise with respect to how the payments to the non-employee spouse are to be calculated and taxed when (and *if*) they are received in the future. When this problem is identified during negotiations, a method for making such calculations can be set forth in the agreement to avoid disputes in the future.

Financial planners will need to look carefully at these provisions to make sure that their clients' needs are being met with respect to these potentially valuable (but not guaranteed) benefits. If there is another significant asset of comparable value, the non-employee spouse can be awarded that asset in lieu of any claim to the non-divisible plan. Of course, the parties often simply do not have another asset of comparable value. And, since non-qualified benefits are not guaranteed until they are paid, the employee spouse may not want to give up an existing asset in exchange for a future benefit that may never be paid.

In many cases, the only feasible solution is for the settlement agreement to require the employee spouse to send a portion of each payment he receives to the non-employee spouse.

Generally, to neutralize the tax consequences, it makes sense to structure such payments as alimony if possible. This arrangement, of course, less than ideal for both parties. The employee spouse has the burden of writing checks every month to his ex-spouse for the rest of his or her life, and the non-employee spouse is dependent on the employee's good faith in notifying her of his retirement and of timely and properly sending payment in full.

Another issue that demands careful attention is the surviving spouse benefits of non-qualified plans. The terms of some non-qualified plans specify that death benefits must be paid to an existing spouse at the time of the employee's death. This can be problematic, particularly if the employee has remarried after the divorce. Many such cases end up in court if the Plan Administrator automatically pays the death benefits to the subsequent spouse, notwithstanding the provisions of the divorce which awards the former spouse an interest in the non-qualified benefits.

It is important to understand what will happen to the former spouse's benefit if the employee dies before the former spouse has received her portion of the non-qualified plan assets. Divorce agreements and estate plans should include provisions that dictate what will happen to the non-qualified funds in the event of the employee's death, including whether the employee has remarried or is otherwise not permitted to name the former spouse as the beneficiary of the non-qualified benefits. Divorce agreements and wills can be drafted to make it clear that the former spouse is to receive the funds awarded, even if the Plan Administrator makes the payments to another person (a subsequent spouse or a statutory beneficiary).

B) Government Plans

Retirement plans for many government employees are exempt from ERISA. The federal government's three main retirement plans (the Thrift Savings Plan, Federal Employees

Retirement System ("FERS"), and Civil Service Retirement System ("CSRS")) *are* divisible, but not by any document called a "QDRO." These plans have their own mechanisms for division, which include specialized terminology. Publications and guidelines are available at www.tsp.gov for the Thrift Savings Plan and at www.opm.gov for the FERS and CSRS. The Thrift Savings Plan is similar to a 401(k) plan and relatively easy to divide. However, the FERS and CSRS are very complex plans with several unique qualities. Attorneys and financial professionals are *strongly* advised to familiarize themselves with these plans before attempting to divide them, or even to negotiate the terms of the division. The division of FERS and CSRS is riddled with traps for the unwary or unfamiliar. Similarly, the retirement benefits of those who have served in the military are extraordinarily complex, and require specialized knowledge to be properly divided. No one should attempt to divide (or even discuss dividing) military benefits without sufficient knowledge or experience, and should seek expert assistance.

State and local government retirement systems are specifically exempt under ERISA, and many states have chosen not to apply the principles of ERISA to its retirement systems. This means that in some cases, the retirement benefits will not be divisible by any method. If one of the parties is a state or local government employee, investigate this issue at the beginning of the case to determine whether the benefits are divisible. It is worth inquiring in every case, since there is often a complex mix of benefit plans and it is crucial to make a determination based on each employee's specific benefits. The remedies in situations where state and local retirement benefits are not divisible or transferable are the same as described above for non-divisible corporate retirement plans.

C) IRAs

Contrary to popular belief, you do not need a QDRO to divide an Individual Retirement Account (IRA). IRAs are not subject to ERISA. The provision for the tax-free transfer of IRA funds between spouses in connection with a divorce is found at 26 U.S.C.A. § 408(d)(6). A transfer may be made to a spouse or former spouse under this section if it is pursuant to a decree of divorce, or a written instrument incident to a divorce. The "written instrument" can be a separation agreement connected to a divorce, or a decree requiring payment of support to a spouse or former spouse.

A letter of instruction and copy of the divorce decree and (if applicable) agreement should suffice to transfer funds from an IRA in a divorce case. This is known as a "trustee-to-trustee transfer," and it should not result in tax consequences to either party, if it is clear that the transfer is incident to a divorce. Many financial institutions that sponsor IRAs have simple forms to fill out that will effectuate the tax-free transfer of funds. One reason that there is a common misperception that a QDRO is necessary to divide an IRA is that this is often what telephone representatives tell people who call financial institutions and inquire as to how to divide their IRAs in connection with a divorce. These representatives often say that they need a "court order" or a "QDRO," but what they really need is a copy of the divorce decree and agreement, to prove that the division is truly related to a legitimate domestic relations action. However, in many situations, it may turn out to be simpler and more expedient to prepare a separate court order, similar to a QDRO (but which does not make reference to ERISA) which directs the transfer of IRA funds in connection with the divorce.

In states that have a bifurcated divorce procedure, IRA funds can be transferred between spouses prior to the entry of a final divorce decree. A written Settlement Agreement which

provides for the transfer of funds and makes it clear that the parties are divorcing should be sufficient. However, to eliminate any possibility of not complying with §408(d)(6) for tax purposes, it is often prudent to simply prepare a separate order calling for the transfer of the IRA funds between the spouses as part of the divorce process. This order can be entered prior to the entry of the final divorce so that the funds can be transferred before the divorce is final.

There are some critical differences between an IRA transfer and the division of a qualified defined contribution plan. I've encountered an increasing number of cases in which a lack of knowledge about the difference between the transfer of defined contribution funds under a QDRO and the transfer of IRA funds from one former spouse to another has created a huge problem. Divorce lawyers tend to lump IRAs and 401(k)s together and assume that the division of each is pretty much the same, but this is not always the case.

One of the ways this confusion can cause substantial problems is when the intent is for the spouse to receive the transferred funds in cash, rather than a rollover to another retirement account. I have had several cases in which some variation of the following has occurred: The parties agreed that the wife would receive a lump sum from the retirement account of the husband. The specific dollar amount was important; in one case, for example, it represented the (six figure) amount owed by the husband to his former wife in unpaid support obligations. The wife agreed to the arrangement because she was under the impression that the funds received, while taxable, would not be subject to the ten percent early withdrawal penalty, even if she received them as cash. The parties (and their counsel) all assumed that the funds could be transferred by QDRO. If anyone involved recognized that the funds were in an IRA, instead of a 401(k), it is clear that they did not realize that it would make any difference. The court order that

was entered to memorialize the arrangement specified that the dollar amount would be transferred from "Husband's 401(k) to the Wife, by QDRO."

When the husband's counsel attempted to prepare the QDRO, however, he learned that the funds were in an IRA, not a 401(k). The wife would not accept an IRA transfer, because she needed cash - that was part of the basis for her willingness to agree to the arrangement. If the funds had been transferred to the wife by QDRO from a 401(k), they would not have been subject to an early withdrawal penalty. She would have been able to receive the funds in cash, subject only to income tax.

However, since the funds were in an IRA, not a 401(k), they could only be rolled over into the wife's IRA. In order for her to receive any cash, she would have had to take a distribution from her IRA, which would be subject to an additional ten percent penalty – which represented a substantial amount of money. The net result for the wife was that she would receive significantly less cash from the transfer than anticipated. The parties had to go to court to resolve this issue, since the husband's position was that he had complied with the court order and transferred exactly the amount he had been ordered to pay to his former wife, and it was not his concern if she was subject to additional penalties.

Financial professionals are far more knowledgeable about such matters than divorce lawyers (or their clients). If possible, it is worthwhile for your client to have you review the proposed divorce agreement before it is finalized to see if you can identify mistakes like this before they cause problems for the parties.

III. <u>COMMON MISTAKES: DEFINED CONTRIBUTION PLANS</u>

A) <u>Failing to Set a Clear Date of Division</u>

Many settlement agreements fail to state a precise date for the division of retirement assets, which creates quite a bit of QDRO litigation. <u>Always</u> state the date as of which the account is to be divided ("Husband is awarded one-half of the account balance as of May 1, 2017" (or the date of the Final Judgment and Decree, or the date of retirement, or any other date to which the parties have agreed)). If you don't include this simple, clarifying information in the agreement, you may find yourself litigating about whether the parties intended the benefits to be divided as of the date the divorce was filed, the date of the mediation, the date the agreement was signed, the date of the Final Judgment and Decree, the date of retirement, or some other date. In a defined contribution plan, if the market spikes up or down, and the agreement is not specific ("Husband is awarded one-half of the account balance"), the parties may fight ferociously over which date of division should control. Many thousands of dollars could be at stake for your client.

The only exception to this rule is when a specific dollar amount is awarded in a defined contribution plan, and the parties do <u>not</u> intend for this amount to be adjusted for earnings and losses. If the parties have agreed that the Husband shall receive exactly $50,000 from the Wife's defined contribution plan, then the date of division is not relevant. In that instance, you *still* need to indicate the parties' intent ("Husband is awarded exactly $50,000.00 of the account balance as of the date of account segregation following the approval of the QDRO by the Plan Administrator."). Remaining silent on this issue in the agreement is an enormous mistake.

One simple thing that can make the entire QDRO process run more smoothly is to use a month-end or first-of-the-month date for the date of the division. In many retirement plans, it is

very easy to obtain a value of the benefit as of the first day of the month (or the last day), but surprisingly difficult to get a valuation as of any other date during the month. For simplicity's sake, it is usually best to pick an easy date for valuation rather than the date of the divorce or the date of the mediation.

Mistakes regarding failing to set a date of division are usually intertwined with the following mistake:

B) Failing to Address Earnings and Losses in a Defined Contribution Plan

There is usually a delay of several months (at least) between the date of division and the date that the funds in a defined contribution plan are actually divided. That is, an agreement may specify that the funds shall be divided as of May 1, 2017, but this division does not actually take place until the QDRO is entered the following January. If the agreement states that Wife shall receive fifty percent of the Husband's 401(k) plan balance as of May 1, 2017, and the account was worth $100,000 on May 1, 2017, but has grown to $106,000 by January 2018, what should the Wife receive when the account is divided? Fifty thousand dollars, or fifty-three thousand dollars? Of course, the scenario can also be the (much more unpleasant) opposite: what if the account had $100,000 in it in May but has been reduced to $80,000 by January? Is the Wife supposed to receive fifty thousand dollars, or forty thousand? The Agreement must specify what happens to earnings and losses on the amount awarded to the Wife between the date of division and the date the funds are actually distributed to her.

Obviously, your position on this matter will depend on which party you represent and the facts of the case. If you agree on a specific dollar amount or percentage of the account as of a certain date, with no adjustment for earnings and losses, then the employee spouse is going to bear all of the potential risk of the value falling, and all of the gain if the value increases. If the

market goes up dramatically, he may be very happy. But if it goes down, he may resent having to transfer $50,000 to his ex-wife, because this now represents a greater percentage of the total account balance. Conversely, the Wife will be happy with her guaranteed $50,000 if the market falls, but unhappy that she is not getting a share of the gains if the market goes up.

Be careful to address these issues as follows:

> *"Wife shall receive 50% of Husband's Enron 401(k) Plan as of May 1, 2017, including investment earnings and/or losses on that amount from that date until the date the funds are completely distributed to Wife."*

OR: *"Wife shall receive 50% of Husband's Enron 401(k) Plan as of May 1, 2017, which amount shall* not *be adjusted for investment earnings and/or losses from that date until the date the funds are completely distributed to Wife."*

NOT: *"Wife shall receive 50% of Husband's Enron 401(k) Plan as of May 1, 2017."*

Note that if you agree that the awarded amount *will* be adjusted for earnings and losses, then neither party's interest should be affected by the amount of time it takes to complete the QDRO process. Even if the account is not actually divided for several years, each party will still get exactly what he or she would have received if the account had been divided on May 1, 2017. Essentially, the Plan Administrator will calculate the benefit in a manner that will make it the same as if a separate account had actually been established for the Wife on May 1, 2017, and then her separate account independently rose and fell with the market between that date and the date the account is actually divided. Nonetheless, it is extremely important to get the QDRO done as soon as possible following the divorce, for reasons that will be discussed in greater detail below.

C) Flat Dollar Amounts and Non-adjusted Percentages

The award of "flat dollar amounts" from defined contribution plans to non-employee spouses can create some of the most excruciating situations in the face of falling account values. Parties who innocently agreed to a flat dollar amount in their divorce agreement before a market crash (for example, parties who agreed in June 2008 that the Wife would receive $50,000 from the Husband's 401(k), which had a balance of $100,000 at the time) can have painful encounters with a changed reality. In many cases, there was no longer $50,000 in the account when the QDRO was finally completed in, say, January 2009. If the account was worth $40,000 at that time, and the Settlement Agreement simply stated that the Wife would receive $50,000 and did not say anything about adjusting the Wife's amount for earnings and losses, the Husband, who agreed in principle to divide the retirement account in half back when it was worth $100,000, was faced with transferring *one hundred percent* of the current account value to his former wife, *plus* additional funds in order to provide the Wife with the $50,000 set forth in the Agreement. In many cases, this meant that the Husband owed the Wife more than the $10,000 needed to simply make up the shortfall, in order to account for the different tax status of retirement money.

Never let your client enter into a divorce agreement which provides for a non-adjustable flat dollar amount (or percentage) without understanding the potential risks. A flat dollar amount or percentage that is not subject to adjustment should only be used in rare circumstances, and only when there are sufficient funds in the retirement account to cover the amount awarded even if the value of the account drops substantially. If your client insists on using a flat dollar amount, you might want to document the fact that you explained the risks to the client and he or she decided to proceed with it anyway.

None of us can be sure, of course, how long the QDRO process will ultimately take, and when we are going to experience a substantial market fluctuation. It is good practice with any retirement account, but especially when transferring a flat amount, to insist that the employee spouse transfer the funds into a stable value fund while the divorce and QDRO are pending. If this is an available option under the plan, it is in the best interest of the parties (and their representatives) to preserve the value of the account in this way, at least until the funds are transferred under the QDRO.

Use language like this in the agreement if the intent is to award an exact dollar amount that is <u>not</u> going to be affected by any changes in the value of the account:

> *Wife shall receive <u>exactly</u> $50,000 from the Husband's 401(k), which amount shall <u>not</u> be adjusted for earnings and losses.*

Note that this language does not confuse matters by including a date of division. If the parties intend to award an exact amount that is not going to change, then there is no reason to include a date, and it will only cause confusion. If the Plan Administrator ultimately requires that a specific date be included in the QDRO, then it should be stated along the following lines: "*as of the date, following the qualification of this Order, that a separate account is established for the Alternate Payee*."

If the intent of the agreement is instead to award a specific dollar amount (instead of a percentage) that *is* to be adjusted for earnings and losses between the date of the divorce and the date the funds are transferred under the QDRO, use language like this in the agreement:

> *Wife shall receive $50,000 from the Husband's 401(k) as of May 1, 2017, which shall be adjusted for earnings and losses from that date through the date the funds are completely distributed to Wife under the QDRO.*

This should provide the Wife with the amount she would have received if the account had been divided on May 1, 2017 and she had received $50,000 in a separate account under the Plan on that date. This means that each party will suffer (or benefit from) a proportionate share of the investment experience over the period between May 1 and the date the funds are actually transferred under the QDRO. In this example, the Wife will ultimately receive more or less than $50,000, depending on what happens to the value of the account before the QDRO is complete. Whenever the funds are finally transferred, it will essentially be as if the funds have been in a separate account in Wife's name since May 1.

These examples should demonstrate the importance of handling flat dollar amounts and earnings and losses with care. If the intention is for the dollar amount to remain constant regardless of the value of the account over time, be sure that this is clear in the agreement. If the intention is to adjust the dollar amount to reflect changes in the market, make this clear instead.

D) Misunderstanding Loans

Existing loan balances in defined contribution plans are often overlooked when drafting divorce settlement agreements. In fact, account statements frequently make it difficult to determine whether an account has an existing loan balance. This is because defined contribution plans often use confusing terms to refer to the total balance. Statements may show a "total balance" of $50,000 in bold type, but show elsewhere that the "total account value" is $75,000 due to an outstanding loan on the account. In most plans, an outstanding loan is considered an asset which should be added to the total balance when determining the true value of the account. However, most plans cannot award any portion of a loan balance through a QDRO. It is important to pay attention to how loans are handled by the Plan Administrator, and to make sure that you are clear in the agreement and the QDRO about whether the balance of any loan will be

“included” or “excluded” from the calculation. This definition is counter-intuitive for many people, and causes a lot of mistakes.

To protect your client from a post-divorce loan surprise, you should determine whether there are any existing loans against the defined contribution plan you are dividing. If there are not, be sure to include language in the settlement agreement (especially if you represent the non-employee spouse), asserting that there are no loans on the account and prohibiting the employee from taking any loans (or other withdrawals) until after the completion of the QDRO and division of the account. It is good practice in every case (even if loans are not an issue) to list the most current account balance available at the time of the agreement so that everyone has a baseline to determine the parties’ understanding of the account value (“Husband’s account in the Dunder-Mifflin 401(k) Plan, which had a balance of $23,415.66 as of May 1, 2017, shall be divided as follows…”).

If there is an existing loan, find out what the loan was used for. If the funds were used to repair the gutters on the marital home to prepare it for sale, the parties might agree that the loan balance should be equally shared. In this case, the Agreement should provide that the loan be excluded from calculations of the non-employee’s share. If, however, Wife has taken $25,000 out of her 401(k) plan to pay your fees or to buy gifts for her boyfriend, the parties may agree that the loan balance should be included when calculating Husband’s share. This means that if there is $50,000 in the account, plus a $25,000 loan balance, Husband will receive $37,500, while the Wife will receive $12,500 plus the $25,000 loan balance, which represents funds she has already received from the plan.

Further, in cases in which one spouse is to receive 100% of a defined contribution plan, you must determine whether there is an outstanding loan because the plan may need to hold back

sufficient funds to cover the loan. Thus, "100%" can be substantially less than that, and it pays to find this out in advance.

E) "Equalizing" Multiple Defined Contribution Plans Incorrectly

Often, the parties have several defined contribution plans and IRAs. In many cases, it is unnecessarily complicated and expensive to prepare a separate QDRO for each plan. Knowledgeable professionals will try to save their clients money by combining the values of all of the defined contribution plans and simply transferring an equalizing amount from one account. This is usually a great idea, but it is often implemented incorrectly so that it ends up costing the parties more to untangle than it would have to prepare separate QDROs. There are several pitfalls that need to be avoided in order for the equalizing transfer to work correctly.

Assume that the Wife has an IRA with a balance of $500 and a 401(k) in her name with a balance of $100. The Husband has an IRA with a balance of $200 and two 401(k) accounts, one with $400 and one with $200. Assume further that the parties have agreed to divide their retirement plans equally. Rather than divide each of the five retirement plans, it is more efficient to add up the total value of the accounts and transfer funds from one account by QDRO.

The Agreement should provide that the parties will exchange account statements for each account **as of a specific date**. This is the critical piece that is most often missed. If you do not provide a specific date, then you create a situation with a "moving target" in which the parties can never complete the calculation and will argue forever about the values in each account. As explained above, it is best to select a first-of-the-month or month-end date of division if possible.

Next, set forth how the calculation is to be completed. Normally, the parties exchange account statements and then determine the total value of all accounts on that date. Then they determine how much must be transferred from one account to the other spouse in order to

equalize the total. It is helpful to include an example so that the calculation method is clear. Of course, you must make sure that the account that the equalizing funds will come out of will have enough assets in it to cover the transfer.

Another common mistake is to try to adjust the equalizing amount for earnings and losses. This is another "moving target" problem. The parties need to understand that earnings and losses can only be adjusted in one account, or else the amount to be transferred will never be calculable. The accounts need to be valued as of a certain date, and then the equalizing amount can be adjusted for earnings and losses from that date forward, *only in the account from which it is to be transferred*. Earnings and losses in the other accounts cannot enter the calculation after the date of division.

These issues are perhaps best illustrated by example. Using the numbers set forth above, the language of the Settlement Agreement would read as follows:

The parties have the following retirement accounts:

(1) Wife's IRA, account number XXX234, with a current balance of $500;

(2) Wife's Lehman Brothers 401(k), with a current balance of $100;

(3) Husband's IRA, account number XXX567, with a current balance of $200;

(4) Husband's Costco Corporation 401(k), with a current balance of $400;

(5) Husband's Acme Corporation 401(k), with a current balance of $200.

It is the intent of the parties to divide these retirement assets such that each party receives an amount equal to one half of the total retirement assets as of May 1, 2017. Within 10 days of the date of the signing of this Agreement, each party shall provide the other with an account statement for May 1, 2017 for each of the accounts in his or her name. The total value of all five accounts as of May 1, 2017 shall be determined, and an

equalizing amount shall be transferred by QDRO from Husband's Costco Corporation 401(k) to Wife. Using the numbers set forth above as an example only, the Wife would receive $100 from Husband's Costco Corporation 401(k), as of May 1, 2017, so that each party would receive retirement assets valued at $700 as of May 1, 2017. The amount awarded to Wife shall be adjusted for earnings and/or losses within the Costco Corporation 401(k) account from May 1, 2017 until the date the funds are transferred to Wife. Using the numbers set forth above as an example only, the QDRO would provide for Wife to receive $100 from Husband's Costco Corporation 401(k) Plan account as of May 1, 2017, plus earnings and losses on that amount from that date until the date the benefit is completely distributed to Wife. Each party shall retain all of the remaining retirement funds currently in his or her name.

This should serve to avoid the need for multiple QDROs, without creating additional conflict over how to determine the "equalizing" amount to be transferred.

Important note: NEVER try to "equalize" defined benefit plans! Agreements that provide for the equalization of defined benefit plans in any fashion are a prescription for disaster. Benefits that are not set up as accounts with specific dollar values and payable as immediate lump sums cannot be properly "equalized." Each defined benefit plan to be divided will require its own separate QDRO.

IV. COMMON MISTAKES: DEFINED BENEFIT PLANS

A) Failing to Clarify the Valuation Date

The date of division or valuation is just as important in dividing a defined benefit plan as it is for a defined contribution plan. With defined benefit plans, the issue is not earnings and losses, but identifying the cutoff point after which the former spouse is not entitled to benefit

accruals based on the employee's continued service under the retirement plan. Depending on how much longer the employee spouse will continue to work for the employer and accrue additional benefits, there could be an enormous difference in the result between "*Wife shall receive 50% of the Husband's benefits under the Disney Pension Plan, determined as of the date of divorce*," and "*Wife shall receive 50% of the Husband's accrued benefits under the Disney Pension Plan, determined as of the date of the Husband's retirement*." Perhaps worst of all would be "*Wife shall receive 50% of the Husband's Disney Pension.*" That lack of specificity pretty much guarantees that there will be a dispute about what this means.

B) Not Understanding the Difference Between a Shared and Separate Interest

Frequently, I receive settlement agreements in cases for which I am asked to prepare QDROs for defined benefit plans, in which it is clear to me that the parties and their advisors did not realize that the non-employee spouse does not have to wait until the employee retires in order to start receiving her share of the pension benefits. A lot of divorce negotiations are based on the often-incorrect understanding that the former spouse cannot receive benefits until the employee does. Most (but not all) defined benefit plans will accept a "separate interest" QDRO if the employee has not yet started benefit payments at the time the QDRO is entered. The alternative is a "shared interest" QDRO, which is the only option available if the employee spouse has already retired and started receiving benefits at the time the QDRO is entered.

Under a separate interest QDRO, the former spouse's benefit is truly separated from the employee's benefit, and the former spouse can make independent decisions about the timing and form of the benefit. The former spouse can start her benefit payments at the earliest date that the employee can start – even if the employee does not start his benefit then. She can also take her benefit in any form available under the retirement plan – regardless of the form of benefit that

the employee chooses for his benefit. So the former spouse could, for example, decide to start her benefit payments when the employee reaches age 60, and choose a monthly annuity form of payment. The employee, however, could decide to wait to retire until he reached age 65, and choose a lump sum payment. Neither party's choices would affect the other's, and the former spouse's benefit will not be affected by the employee's death once her benefit payments start.

Under a shared interest QDRO, everything is controlled by the employee. The former spouse has to receive her benefit at the same time and in the same form as the employee. A shared interest is required when the payments have already begun to be made to the employee, but if that is not the case, a separate interest QDRO provides much more flexibility.

C) Failing to Properly Address Surviving Spouse Issues

Family law attorneys frequently fail to make sure that both pre- and post-retirement surviving spouse coverage are explicitly addressed in the divorce agreement. Surviving spouse benefits are probably the most complex area of QDRO practice, and there are far too many issues involved to fully address here, but financial planners should be aware of some of the most common pitfalls and issues that need to be addressed. Divorce agreements should specify whether the non-employee spouse ("Alternate Payee") is to be treated as the surviving spouse if the employee ("Participant") dies before the transfer under the QDRO is completed. For a defined contribution plan, this can be as simple as making it clear that the Alternate Payee is entitled to receive the funds awarded to her regardless of when the Participant dies ("Wife shall receive her portion of the Husband's Uber 401(k) Plan without regard to the death of the Husband").

Many attorneys do not realize that, in defined benefit plans, payment of a surviving spouse benefit is substantially affected by whether the employee spouse dies *before* or *after* the

commencement of benefit payments. Both situations must be addressed in the QDRO, and thus should be spelled out carefully in the agreement. Special attention should be paid to what will happen if the Participant dies after the QDRO is entered but before the benefit payment has begun. Keep in mind that, since payments normally do not commence until the employee reaches retirement age, this period can last many years. In many defined benefit plans, the Alternate Payee will receive no benefits if the Participant dies before her payments begin, unless the Alternate Payee has been specifically designated as the surviving spouse for purposes of the Qualified Pre-Retirement Survivor Benefit ("QPSA").

Further, the agreement should clarify whether the Alternate Payee is supposed to be the surviving spouse for the Participant's entire benefit, or just for the portion of the benefit awarded to her. For the Alternate Payee, this can mean the difference between having her benefit remain unaffected by the Participant's pre-retirement death, and having her benefit *reduced by half* upon his death. This will also affect the Participant's ability to leave a survivor benefit to any subsequent spouse. Some plans will accept language providing for the Alternate Payee to receive "that amount of the QPSA necessary to ensure that the Alternate Payee's benefit is not reduced as a result of the Participant's death prior to benefit commencement." This is often a good compromise. In any event, financial advisors need to be sure that they understand exactly what will happen upon the Participant's death, before and after benefit commencement.

As discussed above, in *most*, but not all, defined benefit plans, a separate interest QDRO will insure that the Participant's post-retirement death will not affect the Alternate Payee's benefit. Therefore, the Alternate Payee does not need to be designated as the surviving spouse in order to receive her full benefit following the post-retirement death of the Participant. However, if the plan does not provide for a completely separate interest (and plans at many large

corporations do not), then it is crucial that the Alternate Payee be designated as the surviving spouse for the appropriate portion of the Participant's post-retirement survivor benefit. The parties should determine in advance whether the benefit will be paid as a separate interest in which the death of the Participant will not affect the Alternate Payee. If not, the extent of the Alternate Payee's interest in the post-retirement survivor benefit (often called the "Qualified Joint and Survivor Annuity" or "QJSA") should be defined in the agreement. Again, some plans will accept language providing for the Alternate Payee to receive "that amount of any post-retirement survivor benefit necessary to ensure that the Alternate Payee's benefit is not reduced as a result of the Participant's death following the commencement of benefits."

If the Participant has already begun to receive benefit payments under the retirement plan, then it is normally not possible to do a separate interest QDRO. In that circumstance, the parties will generally need a "shared interest" QDRO, and, under the vast majority of plans, the surviving spouse designation made at the time of retirement will be irrevocable, even upon divorce. One way to think about a shared payment QDRO after retirement is as a "check splitter." Everything about the Participant's benefit has already been permanently determined, including the form and amount of the benefit, and the designation of the surviving spouse. All that can be done at that point under a QDRO in most circumstances is to send out two checks, instead of one, providing a portion of each monthly payment to the former spouse.

Financial planners should also be aware of what will happen to the Alternate Payee's benefits upon her death, before and after benefit commencement. Generally, the benefits will revert to the Participant if they have not begun to be paid to the Alternate Payee before her death, but some plans instead provide that the benefits will revert to the plan. In most (but not all) cases, the QDRO can be drafted to provide for either result.

If the Alternate Payee dies after her benefit payments have begun, in most circumstances, the form of benefit elected by the Alternate Payee at the time of commencement will dictate the result. For example, a single life annuity payable for the lifetime of the Alternate Payee will obviously cease upon the Alternate Payee's death, but a payment form with a term certain might continue to pay benefits to a designated beneficiary after the Alternate Payee's death until the end of the term. Further, some plans permit the designation of "contingent" or "successor" Alternate Payees in the QDRO, to receive benefits payable after the Alternate Payee's death (for example, under a shared payment QDRO where the payments are being made for the lifetime of the Participant). The contingent Alternate Payees must meet the requirements to be considered an Alternate Payee under ERISA (a "spouse, former spouse, child, or other dependent" of the Participant).

Since there are so many variables that can affect the payment of retirement benefits upon the death of either spouse following a divorce, financial advisors should make sure that they and their clients understand what will happen to the benefits upon the death of either party, before and after benefit commencement. One final note that is important to keep in mind is that the Plan Administrator is required to honor the beneficiary designations on file at the time of the Participant's death, even if this conflicts with the divorce decree or estate planning documents. This policy was reaffirmed by the United States Supreme Court in Kennedy v. Plan Administrator for DuPont Savings and Investment Plan, 129 S. Ct. 865 (2009). The Plan is required to follow the instructions of the employee as set forth on the plan's beneficiary designation forms, regardless of whether there is a subsequent divorce decree or other document which purports to award the benefits to someone else. This affects the payment of both defined benefit and defined contribution benefits, and often leads to litigation (for example, between the

Participant's estate and a former spouse when the Plan pays the benefits to a former spouse who is not entitled to receive the benefits under the terms of a divorce agreement, but who remains the designated beneficiary on file with the Plan Administrator). These cases can be heartbreaking (not to mention expensive and time consuming for the estate). Financial advisors should confirm with their clients that all beneficiary designations are properly made and/or revised immediately following the divorce.

D) Failing to Address Supplemental Benefits

Defined benefit plans are far more complex than defined contribution plans, but you would not know that from reading most divorce agreements. In addition to the lack of specificity about surviving spouse benefits, very few agreements say anything at all about cost of living increases, early retirement subsidies, supplements, and disability payments. Since many Plan Administrators require these issues to be addressed in the QDRO, this often becomes a dispute when the QDRO is being prepared, since there is no guidance in the agreement about what the parties intended (and the issue almost certainly never came up during the divorce negotiations). Divorce agreements should set forth exactly what the former spouse's portion of the defined benefit plan will and will not include.

V. AVOIDING QDRO PREPARATION AND IMPLEMENTATION MISTAKES

A) Timing and Responsibility for Preparing the QDRO

A frightening number of divorce agreements do not assign any responsibility for drafting the QDRO, and in some cases, this means that the QDRO is never drafted or completed. QDROs can easily fall through the cracks, since they are not something most clients are familiar with, and each attorney may assume that the other is taking care of it and then forget about it as time passes. Ideally, the divorce agreement should spell out who is going to be responsible for

drafting and submitting the QDRO to the court and Plan Administrator. It is also important to make it clear who is responsible for the fees and costs involved in preparing and implementation of the QDRO. These expenses can be substantial; in addition to attorney fees, some Plan Administrators of defined contribution plans charge $1000 or more to administer QDROs. These fees can be split by the parties, or made the responsibility of one party.

The divorce agreement should also state how soon the QDRO process will begin. In a truly shocking number of cases, the QDRO is not completed for several years after the divorce. I have worked on many cases in which the QDRO was never prepared, although the parties were divorced more than *20 years ago*. While this is extreme, it is not at all unusual for the QDRO be delayed by five to ten years after the divorce. In some cases, the delay will not actually affect the division of the benefits. In most, however, the longer the QDRO is delayed, the more likely it is that there will be a significant complication as a result of the delay.

An array of problems can arise if the QDRO is not entered reasonably soon after the divorce. In defined contribution plans, problems with the calculation of earnings and losses will be exacerbated by the passage of time. Some plans will not be able to calculate earnings and losses prior to a certain past date, because they have changed recordkeepers since then. Companies and plans will merge, go bankrupt, or convert their retirement programs into different types of plans. Employees may leave one company and roll their 401(k) funds into a different plan. Awards that were not clearly defined in the agreement five years ago will seem even more ambiguous in light of changes in account values. If the date of division is not clear, there might be an argument about the contributions made after the date of divorce. Employees may invest their 401(k) funds poorly and lose all the money awarded to their former spouse. And, of course, one of the parties might die, leading to an argument about whether the new spouse, the estate, or

the children are supposed to get the funds awarded in the divorce. This is a risk for both parties, since either way the parties (and their estates, subsequent spouses, and children) will be tied up in litigation that could have been avoided. All of these scenarios are examples from real cases.

While there are many problems that can arise if the entry of a QDRO for a defined contribution plan is delayed, the risks are even greater when it comes to defined benefit plans. One issue that arises frequently is that the employee may retire before the QDRO is entered. This can be extremely costly to everyone involved. Once an employee enters pay status under a defined benefit plan, many irrevocable decisions have been made. At that point, the employee's benefit is calculated based on his lifetime, and it can never be recalculated. This means that the former spouse can only receive a portion of each payment made to the employee (as a "shared interest," discussed above). The former spouse will not be able to get a separate benefit based on her life, and her benefit must be paid in the form of benefit selected by the employee.

If the employee retires before a QDRO is entered for a defined benefit plan, the most significant consequence is often the loss of surviving spouse benefits. The former spouse can usually get something close to the benefits she was originally supposed to receive under the QDRO (but she may have to file a contempt action against him to get her share of the payments he received prior to the implementation of the QDRO). However, the benefit payments will stop whenever the employee dies. In almost all cases, the Plan will never pay surviving spouse benefits to her if he did not designate her as his surviving spouse at the time of his retirement. If the employee remarried, the Plan will pay survivor benefits to the new spouse.

If the employee remarries, retires *and dies* before the QDRO is entered, the former spouse will be out of luck. As discussed above, the Plan Administrator will pay the benefit to the surviving beneficiary of the employee, no matter what the divorce decree says. If the Plan pays

the survivor benefit to the new spouse instead of your client, you might still succeed on a claim against the estate for the benefits paid to the new spouse. A few plans will accept posthumous QDROs, but it can be a very difficult process that is dictated by case-specific factors. It is never safe to assume that a former spouse will be successful in receiving any benefits following the death of the Participant before the entry of a QDRO.

The bottom line is that nothing good can result from delaying the entry of the QDRO. There are so many ways that a delay can cause complex problems that the chances are that your client's interest will be harmed if the QDRO is not completed in a timely fashion. Financial planners will serve their clients well – regardless of whether they represent the employee or the former spouse - if they make sure that the QDRO process is completed as soon as possible. Keep in mind that the QDRO process can take several months to complete, and much of the timing is in the Plan Administrator's, not the parties', hands. So, divorce agreements should not state that a QDRO will be completed by a certain date, but it should set forth the time by which the process will *begin*.

B) Finalizing the QDRO

Once the divorce is final, it is crucial to make sure that the division of retirement assets has been completed before the file is closed – but the parties and their lawyers often make the dangerous mistake of closing the file before the process is complete. The parties need some form of certification from the Plan Administrator that the final QDRO has been received and accepted. For a defined contribution plan, this is often easily determined without a formal letter from the Plan Administrator (although it is best for the parties to have a proper letter for their records), because the transfer of funds is reflected in the employee's account balance, and because the Plan contacts the non-employee spouse once a separate account has been established for her.

Defined benefit plans are less easy to check. The parties and their advisors should **NEVER** assume that the matter is completed simply because they mailed a copy of the QDRO to the Plan. Twenty years from now, after the parties have each remarried and the employee spouse dies, if the Plan Administrator does not make survivor benefit payments to the Alternate Payee and states that it never received the QDRO, she will need to prove otherwise by producing a letter from the Plan Administrator acknowledging receipt of the QDRO and formally accepting it. This scenario is far more common than you might imagine.

C) Help Your Client Analyze Benefit Options and Timing

My clients' financial advisors frequently ask me questions about the timing and distribution of benefits. One of the most common sources of confusion is the widespread misperception that the QDRO must specify what the recipient spouse wants to do with her awarded funds. Actually, QDROs *cannot* contain any distribution instructions for the Plan Administrator. Once a QDRO for a defined contribution plan has been formally approved, the Plan Administrator will segregate the awarded funds into a separate account for the former spouse, and then provide the former spouse with the forms for her to provide her distribution instructions. Those forms will enable her to tell the Plan Administrator whether she wants to take a cash distribution or roll some or all of her funds into another retirement plan (and if so, the forms will ask for her retirement account information for the rollover).

Generally, funds awarded under a defined contribution can be paid in a direct (non-taxable) rollover to another eligible retirement plan, or paid in a (taxable) cash distribution. Cash distributions will be subject to an automatic, mandatory withholding of 20% for federal income taxes, and ultimately will be taxed at the recipient's regular income tax rate (federal, state, and

local) for the year in which the cash is received. However, cash distributions from QDROs will not be subject to the 10% early withdrawal penalty.

For defined benefit plans, if the employee is already retired and receiving payments, payments to the former spouse will start shortly after the QDRO is approved. The Plan Administrator will likely suspend payment of the awarded portion of the benefit while the QDRO is pending, and later make a retroactive payment to the former spouse of benefits that were withheld from the employee while the QDRO was in process. The parties will often need a mechanism in their divorce agreement that spells out what will happen with these payments.

Under a separate interest QDRO, the former spouse can request information directly from the Plan Administrator such as benefit estimates that show her options in terms of timing and forms of payment. Most plans will provide a statement that shows estimated benefit payments at various times (earliest retirement age and normal retirement age) and in various forms (annuity, lump sum). The former spouse can choose when and in what form to start payments, independent of the employee. Former spouses must keep the Plan Administrator informed of any changes to her contact information. When the employee is planning to retire (which will require the former spouse to start benefit payments, if she has not already started), the Plan Administrator will only attempt to contact the former spouse at the address listed in the QDRO unless otherwise notified.

Financial advisors can play an invaluable role in the division of retirement assets. They have knowledge and expertise in this area that divorce lawyers generally lack, and are in a position to help their clients tremendously to avoid future problems. Advisors who successfully convince their clients that it is worthwhile to let them participate in this aspect of the negotiation of a divorce settlement can make a substantial contribution to the successful resolution of the case – at the time of the divorce and in the future.