

**Dividing Retirement Benefits:
QDRO Basics for Financial
Professionals**

Institute for Divorce Financial Analysts
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**Employee Retirement Income Security
Act (“ERISA”)**

- Amended in 1984 to permit retirement plans to make payments from an employee’s retirement plan to a **“spouse, former spouse, child, or other dependent”** if awarded in a **domestic relations action** to provide **“child support, alimony payments, or marital property rights.”**

Qualified Domestic Relations Order

- Order in a domestic relations action that meets the criteria set forth in ERISA and **Section 414(p)** of the Internal Revenue Code.
- Must be approved (“qualified”) by Plan Administrator.
- Effectuates payment of benefits to non-employee.

QDROs are not just for divorces

- Marital property division
- Alimony
- Child support
- Temporary support during divorce process
- Past-due support obligations post-divorce

Typical Divorce Process

- Settlement Agreement negotiated
 - Division of retirement benefits specified in Agreement
 - Agreement is incorporated into divorce decree and entered by the judge
 - Plan Administrator contacted for QDRO information
- **Last step should be first!**

Know the difference between:

- Defined Contribution Plan
- Defined Benefit Plan
- Hybrid Plans (e.g., Cash Balance)

Make sure the Agreement does not lump these together as “retirement” or “pension”!

Defined Contribution Plan

- Employee and employer contribute to a specific account for employee
- Account value fluctuates with the investments within the account
- The amount of the *contributions* is what is “defined”

Example: 401(k) Plan

Defined Benefit Plan

- No specific account for employee
- Benefit based on years of service and salary
- The amount of benefits is what is “defined”

Example: traditional pension plan

Cash Balance Plan

- Hybrid of Defined Contribution and Defined Benefit Plan
- Cash balance plans look like defined contribution plans but are technically defined benefit plans
- There are other types of hybrid plans

Qualified v. Non-Qualified Plans

Non-Qualified Plans are:

- Not subject to ERISA
- Usually **NOT** divisible by QDRO (but an increasing number now permit division by DRO)
- Generally unfunded and not secured (at risk if company goes bankrupt)
- Not guaranteed
- Subject to conditions (such as continued employment)
- May need to be divided “**if, as, and when**” payment is made to Employee

Non-Qualified Plans have terms in their names such as:

- Supplemental
- SERP
- Non-qualified
- Excess Benefit

Government Plans

- In some states, state and local government retirement plans are not subject to ERISA and simply **not divisible** – confirm this *in advance* for each plan.
- Federal government and military retirement plans are divisible, but not subject to ERISA. Governed by *very* complex and specific rules – do **NOT** attempt to do this without experience or expert advice.

A QDRO is NOT necessary to divide an IRA

- Trustee-to-trustee transfer pursuant to a decree of divorce or written instrument (such as a settlement agreement) incident to a divorce under 26 U.S.C.A § 408(d)(6).
- Copy of divorce decree and Settlement Agreement, plus a letter of instruction or form from institution should suffice to transfer IRA funds to a former spouse's IRA in connection with final divorce.
- Sometimes it is easier to just submit a "DRO" than argue about it.

What is the difference between an IRA and a 401(k)?

And, why does it matter in a divorce?

401(k)

- Governed by ERISA
- Sponsored by employers
- QDRO needed to transfer funds without penalty
- Can be divided in any domestic relations action
- Payment can be made to "spouse, former spouse, child or other dependent"

IRA

- Individual Retirement Account
- NOT governed by ERISA
- NOT subject to QDRO rules
- Funds transferable under 26 U.S.C. 408(d)(6)
- Must be “written instrument” related to final divorce
- Transfers can only be made to spouse or former spouse

Real-life example:

- Jim owes Pam \$80,000 in past-due support.
- Consent Order to Resolve Contempt Petition: “Jim will immediately transfer \$100,000 to Pam, by QDRO from his 401(k).”
- Turns out, Jim does not have a 401(k). He has an IRA.
- Pam needs cash.

Who is responsible for the \$10,000 difference?

- Under a QDRO for a 401(k), Pam could receive \$80,000 by electing a cash distribution, subject to mandatory federal withholding of 20%.
- Pam can only receive \$70,000 by withdrawing the funds from the IRA, which is subject to additional 10% penalty.

Another real-life example:

- “John will transfer 50% of his 401(k) to Jane, by QDRO, as of June 1, 2017 and adjusted for earnings and losses from that date forward.”
- John does not have a 401(k). He has an IRA.
- Jane has spent money to have a QDRO drafted, only to find it is not needed.
- The IRA Administrator will not perform any calculations of earnings and losses. Funds must be transferred *as of the date of transfer*.

Common Mistakes:

Defined Contribution Plans

1) Failing to Set a Clear Date of Division

Wife shall receive 50% of the Husband’s 401(k) *as of May 1, 2017 (or “date of divorce,” “date of retirement,” or any other specific date).*

NOT

Wife shall receive 50% of the Husband’s 401(k).

2) Failing to Address Earnings and Losses

• Wife shall receive 50% of the Husband’s 401(k) as of May 1, 2017, which amount shall not be adjusted for earnings and losses.

OR

• Wife shall receive 50% of the Husband’s 401(k) as of May 1, 2017, adjusted for earnings and losses from that date through the date the funds are completely distributed to Wife under the QDRO.

NOT

• Wife shall receive 50% of the Husband’s 401(k) as of May 1, 2017.

3) Beware Flat Dollar Amounts and Non-Adjusted Awards!

Never let your client agree to a non-adjustable flat dollar amount or percentage without understanding the potential risks.

“Wife shall receive exactly \$50,000 from the Husband’s 401(k), as of the date, following the qualification of this Order, of account segregation.”

“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.”

4) Misunderstanding Loans

- Loans are usually treated as an asset in defined contribution plans that is *added* to the account balance (not subtracted from it).
- QDROs (and Agreements) must specify whether the loan balance is to be **included** or **excluded** in calculating the award.
- Loans can never be transferred by QDRO.

5) “Equalizing” Multiple Defined Contribution Plans Incorrectly

- All accounts must be valued as of the **same date**.
- Adjustment for earnings and losses will only take place in the account that the funds are to be taken from.
- **NEVER** equalize defined benefit plans!

Common Mistakes:
Defined Benefit Plans

1) Failing to Clarify the Valuation Date

Wife shall receive 50% of the Husband's Pension Plan, determined as of May 1, 2017 (or "date of the divorce," "date of his retirement," or any other specific date).

NOT

Wife shall receive 50% of the Husband's Pension.

**2) Not Understanding the
Difference Between a "Shared
Interest" and a "Separate
Interest"**

SHARED Interest

- MUST be used if the employee has already started to receive benefit payments.
- Benefit remains payable over the employee's lifetime. Benefits will be paid *if, as, and when* they are paid to the employee.
- Benefit payments will stop at employee's death (unless former spouse is designated as surviving spouse).

SEPARATE Interest

- Benefits are separated (often permanently).
- Former spouse's payments will be made to her over *her* lifetime instead of employee's lifetime.
- Payments will be **actuarially adjusted** to be payable over former spouse's lifetime.
- Former spouse can start to receive her benefits earlier than the employee (but not later).

3) Failing to Properly Address Surviving Spouse Issues

- **Pre- and post-** retirement survivor benefits must **both** be addressed separately. There is a big difference!
- Much depends on whether the QDRO will be shared or separate interest.
- Failure to handle this correctly can easily cause **irrevocable** mistake (for either party).

4) Failing to Address Supplemental Benefits

- Cost of living increases
- Early retirement subsidies
- Disability

Timing and Responsibility for Preparing the QDRO

- Make it clear who is responsible for having the QDRO drafted
- Indicate how soon the QDRO process will start
- Make sure your client understands this **must** be completed
- Delay will make everything more complicated and expensive for both parties – **and might have disastrous consequences**

Finalizing the QDRO: Follow up with the Plan Administrator

Make sure your client receives confirmation that the QDRO has been approved and implemented. He or she should receive a formal letter from the Plan. Read the letter and make sure it is consistent with the intent of the QDRO!

- For a defined contribution plan, simple confirmation that the funds have been transferred should suffice.
- For a defined benefit plan, there **must** be a letter.
- **Keep a copy of the letter!** It may need to be produced 20 years from now if the Plan claims there was no QDRO (after the Participant dies or retires).

Help Your Client Analyze Distribution
Options and Timing

Defined Contribution Plans:

After QDRO approval, Plan Administrator will open a separate account for the non-employee spouse and transfer the funds pro-rata from the employee's account (and make adjustments for earnings and losses if the QDRO provides for that).

Plan Administrator will provide distribution election forms to the non-employee spouse, which is how she will tell them what she wants to do with the money.

- The choices are usually a direct (non-taxable) rollover to another eligible retirement plan (IRA or 401(k)), or a taxable cash distribution.
- Cash received will be subject to mandatory 20% withholding – but **NOT** 10% early withdrawal penalty
- Some Plans will allow the non-employee to keep the funds in the new account.

Defined Benefit Plans

- If employee is already in pay status, benefit payments should start immediately (under a shared interest QDRO).
- Otherwise, under a separate interest QDRO, the non-employee spouse should be eligible to start benefits at the earliest date that the employee could start receiving benefits (even if he does not start then).

- The Alternate Payee can request information directly from the Plan Administrator about the options for the form and timing of her benefits.
- She should be able to receive benefit estimates that show her the projected values if she commences at different dates and in different forms (for example, earliest retirement date vs. the "normal retirement date;" lump sum v. annuity payments).
- She will need to keep her address current with the Plan Administrator.

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