

AVOIDING COMMON MISTAKES WHEN DOING QDROS

- **Thoroughly Understand the Type of Retirement Plan You Will Be Dividing – Is It a DB or a DC Plan?**

Know the plan type and the benefit that can be divided. Will it be a lump sum now? A lump sum later? A stream of income? When will those payments begin and end?

Knowing the plan type and how the benefit can be divided can substantially affect how you may choose to negotiate a resolution regarding the retirement plan.

Include the plan type in your agreement. The plan type is not always clear from the name of the plan. Determine and state who will draft the QDRO, and which client the QDRO attorney represents. Check whether you must use the plan administrator's forms. Take the time to determine how the QDRO fees will be paid.

- **Defined Contribution (“DC”) Plan** – an employee and/or employer make contributions into an account maintained in the employee's name. This is an account-based plan and the value of the account on the statement reflects the value of the participant's interest in the plan.
 - Examples: 401(k)/403(b)/457 plans, PERS Individual Account Program (IAP) accounts, federal Thrift Savings Plan (TSP) accounts.
- **Defined Benefit Plan (“DB”)** – an employee accumulates credits towards their retirement based upon years of service to an employer, and often based on their earned compensation. Typically, the benefit is expressed as a monthly payment beginning at a specified age (e.g., \$2,000/mo. beginning at age 65 years). Also typically, this type of plan does not have an account (and if it does, the account may not reflect the true value of participant's interest).
 - Examples: Teamsters, PERS OPSRP, FERS/CSRS, military.
- **Hybrid Plan** – some plans are a hybrid of the two basic types.
 - Examples: PERS Tier One/Two, cash balance plans.
 - Tip: Do not rely on the PERS Tier One/Two account balance, which almost always does not reflect the true value of the member's interest.
- **IRAs** – IRAs are not a qualified retirement plan and are not subject to QDRO rules. Rather they are divisible under a different section in the tax code, specifically IRC §408(d)(6), by a *transfer* from one party's IRA to the other.

- **Double Check that You Are Using the Correct Name of the Plan**

Federal pension law requires that a QDRO identify the accurate name of the plan.

Remember that often parties have multiple plans because they have had multiple employers over the years, or their employers have offered different types of retirement plans. Being specific about the plan type(s) and name(s) eliminates confusion. For example, if you list the plan name, and upon receipt of a statement that identifies additional plans, it will be clear that these additional plans were not previously listed and a division was not previously negotiated for them.

- Research the exact name of the plan by reviewing the statement and discussing the plan with the client, and with the plan administrator named by the human resources or the accounting department at the employer's company.
- Check with former employers and be specific about the plan name.
- Get an account or benefit statement, and if possible, also a Summary Plan Description (SPD) and the plan's QDRO procedures, if any, for each plan.
- Contact all former employers to discover any plans not disclosed or even known by the parties. Parties may not even know they are entitled to a DB plan.
- Get contact information for the person who will implement the QDRO for the company, who may or may not be the plan administrator.

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- **Watch Out for Non-Divisible Plans**

A qualified domestic relations order (QDRO) means that the plan is covered by the Employee Retirement Income Security Act of 1974 (ERISA). This federal law set minimum standards for pension plans in private industries. Not every type of retirement plan is governed by ERISA. Some plans are not qualified. The types of non-ERISA plans that are not divisible plans are often called supplemental, non-qualified, or excess benefit plans, or may be referred to as a “Golden Parachute” plan for high-level executives. Most federal, state, and local government pension plans are not required to follow ERISA guidelines. However, most of these plans are subject to parallel state law and are divisible by a domestic relations order (DRO). Remember, no matter what your agreement may dictate, plans that are not going to be governed by ERISA might not be subject to division by a QDRO. Many non-qualified plans do not offer survivor benefits. If you find that the plan will terminate upon the death of the employee, it will be critical to identify this in the agreement and address it during negotiations. Consider the appropriateness of obtaining permanent life insurance coverage to protect the recipient spouse.

- Check whether your clients have any non-ERISA plans.
- Find out if there are any options for division provided by the non-ERISA plan.
- Check whether the plan has a survivor benefit option.
- If division is not an option, try to negotiate a credit against other assets.
- You may want to consider setting up a constructive trust or using alimony as a means to equalize the non-ERISA plan benefits.
- Hiring a QDRO expert will help in crafting a resolution that can be implemented.

- **Set a Clear Date of Division**

Be clear on what is to be the date of division to avoid arguments about which date was intended. Some common dates to set the division include the date of filing for the divorce, the date the agreement was signed, the date of the final judgment, or the date of retirement.

- Be sure to come to an agreement upon the date to be used for the QDRO.
- Simplify the implementation of the QDRO by using a date that is the first or last date of the month.

- **Address Both Gains/Losses and Loans for a DC Plan**

DC plans will have market fluctuations that will affect the balance in the account. Specify in the settlement agreement whether earnings and losses affect the balance that will be divided. Be clear about what should happen to the amount of the benefit to be received during the pendency of the division. For example, consider that it may take several months before the terms in the signed settlement agreement are conveyed in a QDRO, approved by the plan administrator, signed by the judge, sent to the plan administrator, and finally, before the plan administrator will dispense the funds. Be sure to indicate if the award should remain frozen or fluctuate. Because the stock market is subject to great fluctuations, one party will be unhappy if gains and losses are not addressed.

- Never include any references for earnings or losses in a DB plan QDRO.
- Conversely, in a DC plan, always include a reference to whether the award does or does not include an adjustment for gains and losses. Do not leave it silent.
- For DC plans, always investigate whether there is a loan balance and address it in your settlement agreement. Read the statement carefully to see if there is an outstanding loan – it can be buried in the later pages of the statement. Moreover, the account balance shown on page 1 may or may not include the outstanding loan balance as a receivable in the total shown for the participant; statements vary. If

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there is a plan loan, specify whether the outstanding loan balance, which is an asset receivable of the plan whether or not included in the account balance shown on page 1 of the statement, should be included in determining the alternate payee's share of the account.

- Always notify the plan administrator that a divorce is pending to prevent new loans against the plan from being obtained.

- **Address any Surviving Spouse Issues in a DB Plan**

All DB plans will have specific rules and elections regarding how benefits will or will not be paid if the participant dies before retirement. These are called survivor benefits. They may be different during employment, at termination, or upon the commencement of benefits. A major malpractice trap is to neglect how a survivor benefit election has been or will be made.

- Retired participants: determine what form of benefit election the participant made upon retirement. If the participant did elect a survivor annuity, you must address what happens to upon divorce. A QDRO may still be necessary to preserve that election for the now-divorced spouse. If the participant elected a single life annuity, then there is no survivor annuity and typically a survivor annuity cannot now be instated, even if both parties agree to it.
- Pre-retirement: is there an option for a separate interest? If so, it will allow the alternate payee to have their own pension benefit completely dissociated with the participant. This may be the best option because it disentangles the parties and it may eliminate the need to address survivor benefits.
- Consider electing a shared interest survivor annuity election if one party has a shortened life expectancy ("shared payment" approach).
- Determine whether any pre-retirement survivor annuity (QPSA) elections are available; if so, agree upon how these will be handled.
- Determine if an early retirement subsidy might be paid to the participant and whether it should be divided proportionally with the alternate payee.

- **Handle the Equalization of Multiple DC Plans Carefully**

Many people will have multiple IRAs and 401k plans. The settlement agreement may dictate how each individual plan is to be divided. Instead, plan balances can be offset against each other. A settlement agreement that has an objective to equalize all of the retirement accounts will reduce the complexity and costs that would result from dividing each plan. To equalize the plans, a date when the calculation should take place must be agreed upon by the parties. Then, address the earnings and losses from this date of valuation forward. Be aware that some plans, including Employee Stock Ownership Plans (ESOPs), are only valued annually. Either choose the valuation date of the ESOP or specify that the ESOP value will be based on the prior valuation.

- Caution equalizing Roth accounts with non-Roth accounts – calculations may be appropriate to gross-up the Roth to its pre-tax equivalent. (The calculation is not as simple as multiplying the Roth account balance by one plus the combined federal and state tax rate; rather, the Roth account balance must be divided by one less the combined federal and state tax rate, e.g., $\$x \div (1-y)$, where x = Roth account balance and y = the combined federal and state tax rate).
- Clearly identify which plan will be subject to the equalizing QDRO.
- Clearly state if the amount will be adjusted for gains or losses.
- Whenever possible, satisfy the equalizing award with a QDRO from a DC plan, not with a transfer from an IRA plan (for the reasons stated below).

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- Never equalize DB plans, unless: (a) a present value calculation has been prepared (note that this may disadvantage the alternate payee from benefitting proportionally from future increases in salary); (b) multiple DB plans for the same participant may be offset against each other if the normal retirement ages under the plans are the same (or other present value calculations are prepared). Consider whether the risks of plan insolvency justify the convenience of the offset.
- **IRAs Are Divided by a *Transfer* Between IRAs, Not by QDRO; Also, a 10% Penalty Applies If Under Age 59½ Years**

IRAs are not divided by a QDRO, but rather are done by a transfer from the IRA that is to be divided to an IRA held by the recipient spouse. The award cannot be paid to the recipient spouse directly; it first must be transferred to the recipient spouse's IRA. Further, there is no exception to early withdrawals from the IRA if the recipient spouse is under age 59½ years like there is for distributions from a "qualified plan" pursuant to a QDRO. IRAs are not "qualified plans" for tax purposes.

 - The parties do not need a QDRO attorney. The general judgment should identify the IRA by the name of the custodian and a redacted account number, and it should specify a fixed dollar or a percentage award. Contact the IRA custodian to inquire what forms will be necessary and complete them with the parties.
 - The recipient spouse typically will need to open an IRA with the same custodian that holds the IRA to be divided.
 - Most IRA custodians will not adjust for gains and losses. Again, specify a fixed dollar award or a percentage – and if a percentage is used, the IRA owner should not make any contributions or withdrawals in the interim.
 - To avoid the 10% penalty if the recipient spouse is under age 59½ years, and if a DC plan exists of sufficient size, consider equalizing the IRA with and dividing the DC plan by QDRO instead of dividing the IRA.

IMPORTANT NOTICES

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