TRISTAR PENSION CONSULTING

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Dividing the Retirement Benefits in Divorce

- Introduction
- Qualified Domestic Relations Orders
- Valid QDRO Determination
- Plan Administrator QDRO Duties
- Access to Plan Information
- When Benefits Can Start
- Division of Benefits
- Defined Benefit Plans
- Defined Contribution Plans
- Tax Treatment
- Modifying QDRO Benefits
- Allocating QDRO Expenses
- Conclusion

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The benefits accumulated under qualified pension and profit sharing plans are often one of the largest assets a married couple owns. If the couple divorces, sometimes their retirement benefits must be divided. Since 1984, federal pension law has provided special procedures enabling family courts to divide pensions in a divorce or separation.

Although the rules governing the division of retirement plan benefits in a divorce are straightforward, strict compliance with applicable legal requirements is necessary to avoid possible plan disqualification or the taxation of benefits to the participant rather than the one receiving the benefits.

QUALIFIED DOMESTIC RELATIONS ORDERS

Pension law authorizes qualified retirement plans to comply with state court domestic relations orders dividing pension benefits, whether by separate court order or a court-approved property settlement agreement. However, the order must satisfy certain requirements in order to be considered a "qualified" domestic relations order (QDRO).

Generally, a domestic relations order is used to provide child support or alimony payments, or to divide marital property as part of a divorce. The QDRO creates or recognizes a right of an alternate payee to receive all or a portion of the benefits payable to a plan participant. The alternate payee is usually the spouse or former spouse but can also be a child or other dependent of the participant.

Plans are required to have written reasonable procedures for determining whether domestic relations orders are QDROs and for administering distributions. The procedures should be designed to ensure that QDRO determinations are made in a timely, efficient and cost-effective manner, consistent with the administrator's fiduciary duties under ERISA.

VALID QDRO DETERMINATION

The plan administrator is responsible for determining whether an order is a QDRO. However, it is not the plan administrator's task to evaluate the fairness of the QDRO but only to determine that the order meets the legal requirements to be a valid QDRO.

To be a valid QDRO, the order must be sent to the plan administrator and clearly specify the following required information:

- The name and last known mailing address of both the participant and each alternate payee covered by the order;
- The amount or percentage of the participant's benefits to be paid to the alternate payee (or the manner in which the amount or percentage is to be determined);
- The number of payments or period to which the order applies; and
- The name of each plan to which the order relates.

A domestic relations order is not a QDRO if:

- It requires the plan to provide an alternate payee with any type or form of benefit not otherwise provided by the plan;

- It requires the plan to provide for increased benefits; or
- It requires the plan to pay benefits that are already required to be paid to another alternate payee under a prior QDRO.

PLAN ADMINISTRATOR QDRO DUTIES

In most cases, the employer is the plan administrator. The employer may be the plan administrator as a corporate entity, if it is a corporation, or as a partnership, if that is its business structure. Or, the plan administrator may be a named individual or a committee appointed by the employer.

The plan administrator is required to promptly notify both the participant and alternate payee of receipt of the order and to provide to them a copy of the plan's written procedures for determining whether the order is a QDRO.

During the review process, the plan administrator must separately account for the amounts that would be payable to an alternate payee, and be careful that benefits are not wrongly paid out to the participant, i.e., participant loans, hardship withdrawals, or withdrawal of employee contributions.

It is the plan administrator's responsibility to declare that a domestic relations order is a QDRO within a reasonable period of time after receipt of the order. The plan administrator must notify the participant and alternate payee as to whether the order is a QDRO. If it is determined that the order is not a QDRO, the plan administrator must provide the following information to the participant and alternate payee:

- The reasons why the order is not a QDRO;
- References to the plan provisions on which the determination is based;
- An explanation of any time limits that apply; and
- A description of any additional information or modifications necessary for the order to be a QDRO and an explanation as to why it is necessary.

As a practical matter, the plan administrator will ordinarily contact its pension and/or legal advisors for confirmation that the court order is a valid QDRO and for assistance in complying with both the procedural notice requirements and implementation of the QDRO.

ACCESS TO PLAN INFORMATION

The plan administrator must provide prospective alternate payees who are involved in a domestic relations order proceeding access to plan and participant benefit information sufficient to prepare a QDRO, such as the summary plan description, a copy of the plan document and a statement of the participant's benefit entitlement.

The plan administrator may condition disclosure of such information to a prospective alternate payee on some reasonable basis for concluding that the request for information is being made in connection with a domestic relations proceeding.

WHEN BENEFITS CAN START

In general, pension law does not require payments to begin to an alternate payee until the "earliest retirement age" of the participant, defined as the earlier of two dates:

- The date the participant is entitled to a withdrawal under the plan, or
- The later of either:

    1. The date the participant reaches age 50, or
    2. The earliest date on which the participant could begin receiving benefits under the plan if the participant separated from service.

Such payments are permitted even though the participant is still employed at the time and intends to remain employed in the future.

Plan documents or written QDRO procedures may permit earlier distribution of benefits to the alternate payee. Many plans avail themselves of the opportunity to provide immediate cash-out of alternate payee benefits in order to avoid the need for segregated accounts, extended division of present and future benefits and other administrative headaches.

DIVISION OF BENEFITS

The method used for dividing the retirement benefits payable to an alternate payee will depend upon whether the plan is a defined benefit plan or a defined contribution plan.

DEFINED BENEFIT PLANS

Generally, a defined benefit plan provides a specific benefit determined and payable at retirement. The benefit is usually determined based upon factors such as years of service and compensation of the participant, and is payable in the form of a monthly benefit.

Because of the nature of the benefits provided by defined benefit plans, division of such benefits in divorce proceedings may raise complex issues. Benefits may have not yet fully vested in the participant, and there may be substantial future accruals which may or may not be taken into account under the QDRO. Valuation of defined benefit amounts may be based on a variety of methods.

Many defined benefit plans do not allow lump sum payouts to alternate payees. Therefore, the alternate payee must accept an annuity form of benefit, which may not be payable until the participant is entitled to retirement benefits.

DEFINED CONTRIBUTION PLANS

Instead of promising a future benefit like defined benefit plans, defined contribution plans provide an individual account for each participant. The account grows through employer and/or employee contributions, earnings and, in some cases, forfeitures from the nonvested portion of the accounts of terminated participants that are reallocated to the remaining participants.

For defined contribution plans, the alternate payee generally receives a percentage of the participant's vested account balance (such as 50%) as of a particular date, although a dollar amount may be specified. If the parties agree as to the division fraction and if immediate distribution is permitted and selected, the only remaining issue may be how currently to value the alternate payee's interest since many defined contribution plans are not valued on a daily basis.

TAX TREATMENT

Payments to a participant's spouse or former spouse are taxable to the spouse. The spouse or former spouse of the participant may elect to have all or a portion of a lump sum payment pursuant to the QDRO directly rolled over to an IRA or another qualified retirement plan, thereby deferring the tax. Any portion not rolled over is generally subject to federal income tax as well as any applicable state income tax but not the 10% early withdrawal penalty.

Distributions to other alternate payees, such as the child of the participant, are taxed as income to the participant, may not be rolled over and are not subject to the 10% early withdrawal penalty.

MODIFYING QDRO BENEFITS

Earlier this year, the DOL issued Advisory Opinion 2004-02A regarding modifications made by a court to an existing QDRO. This guidance states that a new domestic relations order covering the same parties can alter a prior one so long as the new order meets the qualification requirements for a QDRO. Generally, the changes would only apply to future payments.

ALLOCATING QDRO EXPENSES

In May 2003, the Department of Labor (DOL) issued Field Assistance Bulletin (FAB) 2003-3, which completely reversed its prior position regarding charging an individual participant's account for the fees related to a determination of the validity of the participant's QDRO. Prior to FAB 2003-3, plans were permitted to pass on QDRO determination expenses to the plan as a whole but not directly to the account of the participant involved in the QDRO. Plans are now permitted to allocate reasonable expenses associated with QDRO determinations directly to the participant's account.

In order to take advantage of the DOL's new position, the plan's document may need to be amended to include specific provisions for the allocation of expenses. In addition, plans must include information in the summary plan description concerning any expenses that could be charged against a participant's account.

CONCLUSION

QDROs require special language and should be carefully reviewed to make sure they meet the requirements of the law and are administrable under the terms of the plan. The protection afforded by the federal government to a divorcing spouse adds one more administrative chore for the plan administrator. But with proper consulting and legal advice, the plan can handle QDROs without a great deal of strain.

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