COMMON QDRO MISTAKES TO AVOID

Benefit Your Clients by Heading Off These Preparation and Implementation Mistakes

By Emily McBurney

Retirement assets are often the most substantial part of a marital estate, but there is a surprising lack of knowledge about how to divide such assets among divorcing parties and their lawyers, 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.

In the last two issues of the Journal, we explored some of the most common mistakes related to **defined contribution** plans (Part 1) and **defined benefit** plans (Part 2). In this last installment of the series, we will address common errors related to drafting and implementing QDROs in general.

1 | 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 most clients are not familiar with them, 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 $1,000 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 several cases in which

the QDRO was never prepared, even though the parties were divorced more than 20 years ago. While this is an extreme example, it is not at all unusual for the QDRO to be delayed 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.

The issue: 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 record keepers 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 drawn from real cases.

Trouble With Defined Benefit Plans

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 their 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 in the previous article). The former spouse will not be able to get a separate benefit based on their life, and their 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 they were originally supposed to receive under the QDRO (but may have to file a contempt action to get their share of the payments 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 if the former spouse was not designated as such at the time of 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

Nothing good can result from delaying the entry of the QDRO. There are so many ways that a delay can cause complex problems that chances are 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 the QDRO will be completed by a certain date, but it should set forth the time by which the process will begin.

2 | 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.

Defined benefit plans are less easy to check. The parties and their advisors should **NEVER** assume that the matter is completed just 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, the payee 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.

3 | ANALYZING 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 their awarded funds.

In fact, 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 to provide their distribution instructions. Those forms will enable the spouse to tell the Plan Administrator whether they want to take a cash distribution or roll some or all of the funds into another retirement plan (and if so, the forms will ask for retirement account information for the rollover).

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

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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 specific 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 the 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, normal retirement age, etc.) and in various forms (annuity or 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 contact information. When the employee is planning to retire (which will require the former spouse to start benefit payments, if they haven't already started), the Plan Administrator will only attempt to contact the former spouse at the address listed in the QDRO unless otherwise notified.

Our Responsibility

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 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.

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Emily is an Atlanta attorney whose practice has been devoted exclusively to QDROs and the division of retirement assets in divorce cases for nearly 20 years.

In addition, Emily is a popular speaker and is frequently invited to give presentations on this subject to legal and financial professional organizations nationwide.

For more information, visit www.emilyqdro.com.