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Breaking Up Is Hard To Do: Determining the Qualification of a Domestic Relations Order

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Margaret has provided third party administration services to the Kramer Advertising, Inc. Profit Sharing Plan (the "Plan") for three years. One Monday morning, Margaret gets a call from the owner, Ted, letting her know that he has just finalized his divorce. Acting as Plan Administrator for the Plan, Ted has received a domestic relations order ("DRO") from his ex-wife to divide his account. Margaret provides certain 3(16) designated plan administrator services to the Plan, including determining whether a domestic relations order is qualified, approving the segregation of the alternate payee's benefit, and authorizing distribution to the alternate payee. Ted sends her the DRO late that afternoon. Margaret quickly reads it over, noting the ex-wife, Joanna, has been awarded 40% of Ted's account under the Plan, to be paid in quarterly installments over five years, and decides she will do a more thorough review the next day. When she returns to the office in the morning, she already has five voicemails: three from Joanna and two from Joanna's counsel. They want to know when funds will be distributed. Yikes! It seems Margaret may be caught up in a bit of residual bad blood. She wants to handle this as quickly as possible without making any errors. What are the steps that she will need to follow?

Domestic Order in the Court

With only limited exceptions, participants' benefits in qualified plans cannot be assigned or alienated. This requirement is found in Section 206(d)(1) of the Employee Retirement Income Security Act of 1974 ("ERISA"), and Internal Revenue Code (the "Code") Section 401(a)(13). Because of this, a participant generally cannot promise his or her interest under the plan to someone else and the benefits cannot be attached by creditors. There are some exceptions to these restrictions. Possibly the most common exception is a *qualified* domestic relations order. If the Plan Administrator receives a DRO, and then determines that order is qualified, all or part of the affected participant's account or benefit, as applicable, in the plan can be assigned to someone else pursuant to that DRO.

What is a domestic relations order? A DRO is any judgment, decree, or order (including approval of a property settlement agreement) that relates to the provision of child support, alimony payments, or marital property rights. The DRO must be providing these rights or payments to a

spouse, former spouse, child, or other dependent of the participant. The DRO must also be issued pursuant to state family or community property law. Note that the DRO must be a formal order from a court, and not a private agreement entered into by two parties.

What does a DRO do? A DRO is relevant for plan purposes if it is *qualified*. A Qualified Domestic Relations Order ("QDRO") creates or recognizes an alternate payee's right to, or assigns to an alternate payee the right to, receive all or a portion of the benefits payable under the plan with respect to a specific participant.

Who is the alternate payee? The alternate payee can be any spouse, former spouse, child, or other dependent of a participant who is recognized by a DRO as having a right to receive all or a portion of the participant's benefits payable under a plan. Although DROs and QDROs most typically arise under divorce proceedings, the Code specifically allows a current spouse to be an alternate payee and for the DRO to be used to clarify marital or community property rights. Therefore, although unusual, it is possible for a married couple to receive a DRO from a court without actually filing for divorce. It is critical to note that this limited selection of possible alternate payees does *not* include the divorce lawyers for the parties.

What makes a DRO qualified? To be qualified (and, therefore, a permitted exception to the anti-assignment and anti-alienation rules), a DRO must meet the requirements of Code Section 414(p). To do that, a DRO must clearly state:

1. The name and last known mailing address of the participant and alternate payee(s);
2. The amount or percentage of benefits to be paid by the plan to the alternate payee(s), or the manner in which such amount will be determined;
3. The number of payments or period to which the order applies; and
4. Each plan to which the order applies.

Usually, Plan Administrators also require, even if provided under separate cover, the Social Security number of the alternate payee, so that tax forms may be issued when distributions are made.

QDROs have broad authority to divide and award the benefits under the plan. However, they are subject to certain restrictions, namely that:

1. A DRO cannot require a plan to provide any type or form of benefit, or any option, not otherwise provided under the plan.
2. A DRO cannot require a plan to provide increased benefits (determined based on actuarial value).
3. A DRO cannot require the payment of benefits to an alternate payee that are required to be paid to another alternate payee under another order previously determined to be a QDRO.

Consider the DRO presented by Joanna. It purports to award Joanna with 40% of Ted's vested account under the Plan, paid in quarterly installments over five years. What additional information will Margaret need to evaluate whether this is permissible? First, the Plan must allow for installments as a form of distribution. This is a form of benefit and the DRO cannot force the Plan to allow installments if the Plan document does not so permit. Also, as of what date is the 40% assessed? The date the couple separated? The date Joanna first filed for divorce? The date the divorce was final? The date the DRO is presented to the Plan Administrator? If a Plan Administrator is to administer the DRO, all provisions must be clear for it to be qualified.

Procedures for Handling QDROs

ERISA requires that all plans have a written procedure to determine whether a DRO is qualified. Many document systems automatically provide QDRO Procedures to be adopted by the plan sponsor. Under these procedures, the plan is required to promptly advise both the participant and each alternate payee (remember: a former spouse and child could be covered by the same order, and each could be an alternate payee) that it has received a DRO, provide them with the procedures, and tell them that the Plan Administrator is reviewing the order for qualification. If amounts are being paid to the participant during the period of evaluation, the portion of those payments that would, pursuant to the DRO, belong to the alternate payee must be held back by the plan until the determination of qualification is made. If the participant or alternate payee wants the Plan Administrator to work directly with a representative – such as the divorce attorney – they may designate such person for communications.

The Plan Administrator must then determine whether the DRO is qualified within "a reasonable period." If the DRO is determined not to be qualified, the Plan Administrator must advise the parties of that fact and outline why such determination has been made. While this step may be held back until the back-and-forth process between the DRO drafter and the Plan Administrator is complete, if the DRO is ultimately determined not to be qualified, any payments that have been held back for the alternate payee may then be released to the participant. If the DRO is determined to be qualified, the Plan Administrator should advise the parties, and take action to segregate the alternate payee's interest.

The terms "promptly" and "within a reasonable time" are not defined in the Code, ERISA, or any regulations. The law does appear to consider an 18-month period after receipt of the DRO to be the outside range of the reasonable time.

On a practical basis, it is critical that the DRO be written in a manner that permits the Plan Administrator to carry out the order without running the risk of a dispute about what was supposed to be paid to the alternate payee. Therefore, the Plan Administrator must review the DRO carefully to ensure that there are no ambiguities that could create a problem when the payments are made to the alternate payee. If there are ambiguities, the Plan Administrator may either advise the parties of its interpretation of the relevant language or ask that the parties clarify the language of the DRO.

Some plans, particularly larger plans, may offer participants and alternate payees a fill-in-the-blank "form" QDRO to make complying with the review process easier. The plan may not force the parties to use the form QDRO, but it may encourage its use by charging the parties less for the review process. A well-written form document should ensure that the DRO contains the necessary elements and avoids ambiguities or impermissible provisions.

How the Process Actually Works

This is how Margaret should handle the DRO from start to finish:

1 – Acknowledge Receipt. Within one to two business days after receiving the DRO, Margaret should send an acknowledgement, along with the Plan's QDRO procedures, to the participant and alternate payee. Joanna may be anxious for her distribution and calling sooner, but one to two business days should generally be considered prompt.

2 – Review the proposed DRO's compliance with the Code and ERISA. Once acknowledgement has been sent, Margaret will need to review the DRO and determine whether it is qualified. At a

minimum, the DRO will need to provide the name and mailing address of both Ted and Joanna, the name of the Plan, the benefit being awarded to the alternate payee, and how payment of the award will be distributed. Upon review, Margaret notes that the names and addresses are included for both parties, as is the name of the Plan. However, the DRO only notes that Joanna is awarded 40% of the vested account, but does not contain sufficient information as to when that amount will be determined. Further, the DRO cannot provide a benefit or payment method that is not permitted under the terms of the Plan. Margaret double-checks the Plan document and confirms that installments are not a permissible form of distribution. As such, the term defined under the DRO (quarterly payments over five years) is not allowed.

3 – Inform the relevant parties of any missing information. Based on Margaret's review, the DRO cannot be qualified as currently written. Margaret will need to inform Ted, Ted's counsel, Joanna, and Joanna's counsel that it does not meet the Code's requirements. Margaret must let them know the specific deficiencies so that they can be corrected (and may refer to the specific Plan provisions that the DRO contradicts, if applicable). She does not need to tell them how to redraft the DRO to comply with the Code or provide sample language, but identifying specifics as to why it does not meet the requirements should help avoid unnecessary back and forth.

4 – Review the updated DRO and make a determination. After Margaret provides a written explanation of the deficiencies to the parties, she receives an updated DRO from Joanna's counsel. This time, the DRO specifies that Joanna is entitled to 40% of Ted's vested account under the Plan as of February 14, 2020, the day the divorce was finalized. The DRO also clarifies how interest should be accrued (or not) between the date of split and the actual segregation of Joanna's portion. It stipulates that Joanna's portion should be segregated and paid to her as a lump sum as soon as administratively feasible. The DRO now complies with the Code's requirements and does not violate the terms of the Plan. Margaret finds that it is qualified and informs Ted, Ted's counsel, Joanna, and Joanna's counsel of this in writing.

5 – Segregate the alternate payee's account. Except for the barrage of emails from Joanna, the worst is over! The Plan is valued daily. Margaret reviews the trust records and finds that the value of Ted's account was $100,000 on February 14, 2020. Margaret establishes a new account under the Plan for Joanna's benefit and transfers $40,000 (adjusted, if required by the DRO, for earnings between February 14, 2020, and the date of the segregation of Joanna's interest) from Ted's account to Joanna's. The assets can remain invested in whatever Ted's investments were, or the Plan's QDIA, unless the DRO specifies otherwise or Joanna makes some other election.

6 – Distribute funds to the alternate payee. In this case (and in many cases), even though Ted has not had a distributable event, the terms of the Plan document allow an alternate payee to receive a distribution in the absence of a distributable event so long as it is done for purposes of complying with a QDRO. (Not all plans permit this; in fact, it is not uncommon in a defined benefit plan for a plan to require that the participant attains retirement age before payments may be made.) Once the alternate payee account has been established, Margaret provides Joanna with distribution forms and processes the distribution like normal. The law provides that, if the alternate payee is a spouse or former spouse, the alternate payee pays the taxes on the distribution. If the alternate payee is a child or dependent, the participant is responsible for the taxes (even though he or she does not get the money). As the former spouse, therefore, Joanna is taxed on the distribution. Further, the rules for rollovers apply to Joanna as they would to Ted. As such, she can roll over the entire $40,000+ balance to an Individual Retirement Account in her name.

Runaway Participants, Failing Markets, and Other Wrenches in Your Plans

Plan Administrators are limited by what they know. Suppose that Ted is not the owner of the company, but is instead a rank-and-file employee and a participant in the Plan. Suppose further that Ted is over age 59½ and eligible to receive an in-service distribution at any time. Joanna files for divorce and, on the day the divorce is finalized, Ted requests a distribution of his entire account as a direct rollover to an Individual Retirement Account in his name. The Plan Administrator processes the distribution, unaware that the divorce is in process. A few weeks later, the Plan Administrator receives the DRO from Joanna's counsel. What happens now? The money is already out of the Plan and Joanna will have to go back to the court to correct the terms of the DRO to reflect the IRA.

What if the Plan Administrator was aware of the divorce proceedings at the time that Ted asked for a distribution? Should he or she prevent Ted from taking a distribution? It is important to remember that the alternate payee has *no* rights to Ted's account absent a QDRO. Some QDRO procedures require that the Plan Administrator place a hold on the participant's account if he or she knows that a divorce is pending. If the procedure so provides, it must be followed. However, be careful in wording and carrying out this procedure; not all divorces end with a split of the retirement account. How will the Plan Administrator know that the divorce is no longer pending if no DRO is ever received? (In some jurisdictions, the divorce court issues an order to all litigants that they may not take action to prejudice the assets of the marriage while the divorce is pending. In such a situation, a request by Ted to take a distribution would constitute contempt of that court order. This permits the court to be responsible for policing the behavior of the parties, rather than a Plan Administrator.)

Luckily for Joanna, the divorce was finalized before the markets took a significant hit from the coronavirus. What if the parties had considered the total account value of $100,000 when drafting and the DRO had instead specified that Joanna was entitled to a flat dollar amount of $40,000? By the time Joanna contacted the Plan Administrator for segregation of the account, the market had been affected by the coronavirus and Ted's assets in the Plan were only worth $60,000. Is Joanna still entitled to the full $40,000, or should she share in the market loss? Assuming the QDRO states just the sum with no other contingencies, Joanna is entitled to the full $40,000, which will leave Ted with only $20,000. The parties can go back to the court and amend the QDRO to reflect the market loss, but it is up to the parties to identify the issue and resolve it to their satisfaction. (And here is a hint for the Plan Administrator: be sure to insist that a QDRO specify that, if the participant's account is worth less than the flat dollar amount at segregation, the alternate payee will get the full account and that this will be considered to fulfill the QDRO's assignment.)

Although the QDRO dictated distribution to Joanna should occur as soon as administratively feasible, what if Joanna had refused to return completed distribution forms? Must (or can) the Plan Administrator do anything? Although Joanna is entitled to an early distribution pursuant to the QDRO, and such early distribution is permissible, it is likely nothing in the Plan requires distribution of the alternate payee's account. So long as Joanna's account balance does not fall within the cash-out limits of the Plan and the Plan is not terminated, she can keep her account in the Plan if she so chooses.

So Ordered

Because the rules for QDROs are sparse compared to the governance of other areas affecting qualified plans, they are vulnerable to ambiguity. They benefit from a methodical approach

developed through specific plan procedures. Luckily, Margaret is equipped with model procedures and the knowledge she needs to apply them. Her future looks terrific.

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