A QDRO is a Terrible Thing to Waste

While we're pretty sure that every attorney who practices in family law has heard the phrase, and is at least superficially familiar with, Qualified Domestic Relations Orders (QDRO), there are a number of nuances and aspects of same that probably warrant emphasizing. The purpose of this article is to do exactly that – bring to the fore various elements of a QDRO, some of the key things to keep in mind and that need to be done.

Perhaps the most important thing is that you need to get the QDRO done, and it needs to be done by someone expert in QDROs. The expertise is usually by someone, or some firm, that works specifically in this area – whether it be a firm that focuses on QDROs in particular, or a pension expert. This is rarely the accountant, and often not the attorney. While it's not the place of this article to specifically recommend any one or business in particular, we would of course be more than pleased to do so if asked. The point here though is, as like so many other things in our professional lives, a QDRO should be done by someone who thoroughly understands its nuances.

Of equal importance with having it prepared by the right person/firm, is simply having it done. We suspect that most of our readers know firsthand, or indirectly, of horror stories of what has happened when a QDRO wasn't done timely. I'll illustrate one horror story in which I was called in to assist. For whatever reason, the QDRO had never been done, and the husband who had the pension account died. This was now a few years after the divorce. To make matters worse, it was a profit-sharing plan type account where a substantial portion of the account was invested in the Company's stock, and that Company was experiencing a severe contraction in its stock price. Because the husband had died without a QDRO in place – and to make matters worse, without even a will – you can imagine the nightmare of who was going to speak for the husband's estate. This pension account was in limbo for an extended period of time while this was being negotiated and litigated. Of course, there was the anger and frustration building up by the very alive ex-wife who was watching her share of the nest egg evaporate before her very eyes. To add insult to that injury, not only was there a dramatic loss in value in the plan, but there were significant legal, as well as accounting, fees paid by both the estate of the deceased, as well as the ex-wife. Literally, everyone lost big time in this, except of course for the attorneys and the experts. Thus, the two biggest admonitions as to a QDRO are to get it done immediately and get it done right.

It is helpful to understand the types of assets that are subject to, or need to be addressed via, a QDRO, and those to which a QDRO does not apply. Succinctly, a QDRO is applied only to qualified plan accounts – typically meaning a profit-sharing plan, pension, 401(k), 403(b), etc. A QDRO does <u>not</u> apply to, is <u>not</u> used for, IRAs of any kind. That would be whether it's a traditional deductible IRA, a non-deductible IRA, or a Roth IRA. The process of allocating any IRA funds between divorcing spouses is much simpler than as to a qualified plan account, since no QDRO is required. In fact, no document of any particular specified nature is necessary – other than written direction to the trustee (often a bank, brokerage firm, or mutual fund) of the IRA. While such a trustee may have certain additional requirements or make additional demands (for instance perhaps a copy of the applicable portions of the PSA), none of that is a tax requirement.

Note that there is no tax or other statutory restriction on how you allocate retirement funds – whether via QDRO or through an IRA account. That is, as part of the divorce process, these types of assets can be allocated between the spouses in any fashion to which you agree (or to which the Court orders). Thus, this type of asset can also be a very effective tool for fine-tuning the dividing of the marital estate.

In the process of dividing these types of retirement assets, unlike the situation for many of the other assets typical to a marital estate, tax implications are very important, perhaps even of immediate importance. By way of example and contrast, if you have a one million dollar investment account (non-retirement funds), that happens to have a cost basis of $950,000, then the only direct tax issue with allocating that one million dollars is how much of the gain of $50,000 goes to whom. Oversimplifying the situation, it's not a really big issue. On the other hand, if you have a one million dollar 401(k) account, barring anything esoteric (which is outside the scope of this article), you are looking at a one million dollar "gain" – all ordinary income, not capital gains. In that case, the tax issue is very significant and very real. Interestingly, when we get into a Roth IRA, that same one million dollar Roth IRA (and again, oversimplifying and ignoring esoteric tax issues), is totally without tax – it is money that can be withdrawn, allocated, with no tax consequences. To whatever extent there are tax consequences – think of the one million dollar 401(k) account – taxes must not be ignored in dividing the marital estate.

One further caution – funds coming from an IRA are subject to the traditional age 59 ½ threshold issue. That is, and again ignoring various fine points in the tax area, if funds are distributed out of an IRA account (and this includes an IRA account which exists because funds from a qualified plan, such as a pension, were rolled into it) to someone under age 59 ½, that distribution is not only income subject to tax, but is also subject to a 10% premature distribution penalty. On the other hand, those same funds being distributed via a QDRO from a 401(k) account, or other qualified plan (as long as <u>not</u> rolled into an IRA before then coming out), while the funds are taxable as ordinary income, they are not subject to a penalty. As with so many other issues, there are significant tax complexities involved, and nothing should be implemented without good tax advice.