

The Ins and Outs of Qualified Domestic Relations Orders (QDROs)

By Mark A. Josephson, Esq., CPA, CFP, CFE, CGMA



Retirement assets can be one of the largest assets subject to division during the mediation/divorce process. Sometimes these assets can be overlooked especially in situations where retirement is not in the near future for the divorcing couple. Protecting these assets from unnecessary taxation is a key consideration when drafting the settlement agreement. A qualified domestic relation order (QDRO) is the document required to retain the preferential tax treatment of a qualified retirement account upon transfer by the divorcing plan participant. This article will discuss the fundamentals of QDROs as well as offer tips to avoid unwanted tax consequences. QDROs do not apply to “nonqualified” deferred compensation plans as by definition QDROs only apply to qualified plans.

Qualified Domestic Relation Order

A qualified domestic relation order (QDRO) made pursuant to a divorce allows qualified retirement plan benefits to be assigned to an alternate payee (spouse, former spouse, child, or other dependent). Essentially the alternate payee steps into the shoes of the plan participant. Retirement plans include pension benefits, profit sharing plans and other deferred compensation plans and individual retirement accounts (IRAs).

If a divorce agreement states that a retirement plan will be divided, a court must issue a qualified

domestic relations order, commonly abbreviated as QDRO. A QDRO will instruct the plan administrator on how to pay the plan benefits. Funds from the retirement plan can be used to pay child support, alimony or marital property rights to a spouse, former spouse, child or other dependent of the plan participant. A separate QDRO is needed for each retirement plan. The QDRO must meet all of the requirements set forth in IRC sec 414(p) to be valid.

The order must contain specific information such as:

- the participant name and last known mailing address
- each alternate payee’s name and last known mailing address
- amount or percentage of the participant’s benefits to be paid to each alternate payee
- the number of payments or period to which the order applies
- each plan to which the order applies.

Additionally, the retirement plan documents must be reviewed to ensure the QDRO addresses all the benefits of the plan and does not attempt to obtain a benefit which is not available under the plan and does not omit a benefit that is included in the plan. To assist practitioners in drafting QDROs and to ensure all required information is included in the QDRO the IRS has issued Notice 97-11 which

discusses the issues that should be considered and provides sample language to be included in the QDRO.

Tax Tips and Planning

When the alternate payee is a spouse or former spouse, the receiving spouse will be taxed in the same manner as if they were the original owner of the plan. When the alternate payee is a child or other dependent any distribution is taxed to the plan participant.

Any distribution from a plan not pursuant to a QDRO will subject the participant, not the recipient, to tax on the distribution. An alternate payee spouse or former spouse may be able to roll over tax-free all or part of a distribution from a qualified retirement plan that he or she received under a QDRO to an IRA. This rollover option does not apply to an alternate payee child or other dependent. To qualify for the tax deferral the distribution must be rolled over within 60 days of receipt. A “trustee” to “trustee” transfer is typically necessary to avoid the issuance of a 1099-R which will report the distribution as taxable and possibly generate an IRS inquiry whereby the payee maybe required to provide proof that the rollover is not taxable. Additionally, a “trustee” to “trustee” transfer is typically necessary to avoid federal income tax withholding of 20%.

The 10% early distribution penalty that usually applies to distributions taken prior to obtaining age 59 ½ does not apply to a distribution to an alternate payee (spouse, former spouse, child, or other dependent), regardless of their age. This early distribution exception does not apply to distributions from IRAs, SEP plans or SIMPLE plans.

State and local governments and nonprofit organizations defer taxation of their earnings under IRC sec 457, similar to the way compensation is deferred under IRC Sec. 401 (k). The QDRO rules for these types of plans are met if the distributions are made pursuant to a DRO

(Domestic Relations Order, which is beyond the scope of this discussion). Thus, qualifying payments from an IRC Sec 457 plan to an alternate payee spouse or former spouse will be taxed to the alternate payee and not the plan participant. Additionally, in New York State, pensions of New York state and local governments and the federal government are not subject to taxation. The same tax benefit extends to payments made to a spouse or former spouse under a QDRO/DRO.

Individual retirement accounts “IRAs”

The transfer of one spouse’s interest in an IRA to the other spouse’s IRA pursuant to a divorce is not a taxable event. A QDRO may not be required to divide an Individual Retirement Account or a Simplified Employee Plan (SEP). A letter of instruction and copy of the final judgment and/or settlement agreement should be sufficient. Many financial institutions that sponsor IRAs have simple forms to fill out that will effectuate the tax-free transfer of funds in connection with a divorce known as a “trustee-to-trustee transfer.” A withdrawal from the IRA by the receiving spouse is not exempt from the 10% early distribution penalty merely because it is pursuant to a divorce.

Summary

A thorough review of a client’s retirement assets must be made to identify all assets to be considered when dividing such assets and to identify and address all benefits available under each particular qualified retirement plan. Also, there should be a clear understanding of the types of retirement plans held, such as qualified, individual retirement accounts, and non-qualified accounts, to ensure all required QDROs have been addressed to avoid an unnecessary tax burden.

For more information regarding the Internal Revenue rules governing qualified domestic orders see IRC Sec. 414 (p) and IRS Notice 97-11. Also refer to the Internal Revenue Service’s Publication 575 (2018), Pension and Annuity Income at <https://www.irs.gov/pub/irs-pdf/p575.pdf> and 504 (2018), Divorced or Separated Individuals available at <https://www.irs.gov/publications/p504/>.