QDRO Cash Outs, Equalizations, and Tax Ramifications

by David T. Ruegg

Perhaps one of the most frequent questions that both attorneys and potential clients want to know about the QDRO (Qualified Domestic Relations Order) process is: Can we use the QDRO process to resolve XYZ obligation? The answer to this question, like the answer to many legal conundrums is: it depends. In discussing this topic, it is important to understand both the type of account and the type of obligation client is trying to satisfy.

I. Defined Contribution Accounts

Falling under the umbrella of defined contribution accounts are accounts such as 401(k), 403(b), 457(b), IRA, Thrift Savings Plan (TSP), and similar. These accounts are "investment in money" accounts because their value is completely dependent on how much money employee client ("Participant") invested in the account. Employee's final pay grade, rank, or years of service are irrelevant to the value of these accounts.

A. Cashing Out To Pay Bills

When a client on the receiving end of the QDRO (the "Alternate Payee") asks if they can "cash out," what they mean is: Can I spend my money right now? A "cash out" is different from a "rollover" where the client wants to maintain the tax-deferred status on the funds by transferring into another deferred tax account. A common question that comes up when discussing "cashing out" is whether or not Federal and State tax penalties will be assessed if Alternate Payee is under the age of 59 ½.

If payment is made pursuant to a QDRO, then pursuant to Internal Revenue Code 72(t)(2)(c), Alternate Payee falls within an exception to the normal penalty rules; meaning no tax penalties are assessed. However, ordinary income taxes will apply based on Alternate Payee's tax bracket. As required by IRS rules, Plan Administrators withhold 20% of the funds distributed to Alternate Payee for estimated taxes. Actual taxes are determined after Alternate Payee files his/her tax return. Depending on Alternate Payee's personal tax bracket, the 20% withholding may be an overestimate or underestimate-resulting in a refund or additional tax liability.

This tax exception does not apply to IRA accounts [See Internal Revenue Code 72(t)(3)]. IRA funds can be transferred pursuant to Internal Revenue Code 408(d)(6), but funds cannot be "cashed out" via the same "divorce exception" of a true QDRO. An Alternate Payee should talk to a CPA to find out if special IRA exceptions apply which would allow for an early distribution, such as first time homebuyers or higher education expense exceptions.

TIP: Oftentimes, the Alternate Payee is not the only party that is seeking a "cash out." Many times, the Participant also wants to know if he/she can take money out of his/her own account via the QDRO process to avoid tax penalties. The answer is "maybe" because it depends on how willing both parties are to work with each other.

Under the Employee Retirement Income Security Act of 1974 (ERISA), an Alternate Payee cannot be anyone other than a spouse, former spouse, child, or other dependent of the Participant [ERISA § 206(d)(3)(K), IRC § 414(p)(8)]. As Participant cannot also be an Alternate Payee of his/her own plan, Participant cannot directly "cash out" via the QDRO order.

However, there is nothing stopping Alternate Payee from voluntarily turning over funds received to a third party, even back to Participant. You might be able to guess what I am hinting at… For example: Participant and Alternate Payee agree that Alternate Payee shall receive 50% of the community interest in the 401(k) plus $50,000. They further agree that after the QDRO is complete, Alternate Payee will pay back to Participant the net on $50,000. While there are no tax penalties triggered in this fact pattern (only ordinary taxes on funds received), there is a real danger if the parties are not completely cooperative. ERISA provisions have strict anti-alienation rules which prevent Plan Administrators from turning over funds except in very specific circumstances. Translation: If Alternate Payee decides to break the agreed arrangement and roll over the funds into a traditional IRA account, Participant is going to have to overcome some additional hurdles for a safe return of funds.

Also, calculating proper allocation of income tax can be a real headache when this "creative" procedure is employed. Alternate Payee is still personally responsible for ordinary income taxes on all the funds Alternate Payee receives. Since the Plan Administrator withholds 20% of the funds payable for estimated taxes and actual taxes will not be determined until tax filing in the upcoming year, figuring out who should pay what for income taxes, and at what rate, can be quite confusing.

B. Equalizing Against Other Assets

The most important question that needs to be asked when talking about utilizing a defined contribution account for equalization against other assets is: Is the asset we are equalizing against pre- or post-tax?

Fox example, when a vehicle is sold, the funds received for that vehicle are after-tax, since the vehicle was purchased with after tax money. This means if an equalization is made for a vehicle, the equalization should be adjusted up to account for the fact that the funds received from the defined contribution account will be pre-tax (the exception is Roth accounts).

By contrast, equalization for spousal support arrears would be a pre-tax payoff from a pre-tax account. Just as recipient spouse must include timely spousal support payments as additional gross income, the recipient spouse must include received QDRO funds for support arrears in his/her gross income (included at the time the funds are cashed out).

TIP: Judicial Council Form FL-460 is an excellent form for collection of child, spousal, and family support. It is very detailed regarding the proper tax allocations and withholdings the Plan Administrators should make depending on the type of support. This form can be a very useful tool and should not be neglected when considering options regarding child, spousal, or family support arrears.

C. The Equalization Trap Between Retirement Accounts

Often times I see dissolution judgments that lump together large retirement accounts with the intent to "simplify" the QDRO process by reducing the number of QDROs required. While it may seem like a smart idea to combine multiple accounts into one QDRO to save on QDRO Attorney fees and Plan Administrator fees, consider this hypothetical:

Husband has a 401(k) worth $150K as of date of separation September 1, 2015 and all $150K is comprised of large index fund holdings. Wife also has a 401(k) worth $100K as of date of separation September 1, 2015 but all of her $100K is comprised of employer company stock. In an effort to "simplify" the process, Husband and Wife's attorneys agreed that as of date of separation the community property interest is $250K and in order to equalize, Husband shall pay to wife via QDRO $25K. Fast forward to March 1, 2016, the parties are now ready to proceed on the QDRO. Neither party invested further money into their respective accounts after date of separation because "the divorce process was so expensive." Husband's account stayed relatively the same and is now valued at $151K. However, wife's company recently lost a huge contract and as a result her company stock took a significant hit. Wife's account is now valued at $79K. Although both accounts should still be categorized as 100% community property (combined $230K), because of the way the judgment is written, Wife ends up with only $104K after receiving $25K and Husband ends up with $126K.

The point being: be very careful when equalizing larger retirement assets. A 401(k) held at one company is not the same as a 401(k) held at another company, unless they are invested the exact same way. When possible, retirement assets should be divided in kind and equalization should be used sparingly or only for smaller accounts where the risk is lower that a market swing will cause a grossly inequitable result, as in the hypothetical above.

II. Defined Benefit Accounts — What About Buyouts?

In general, defined benefit accounts have much less flexibility for "creative ideas" when talking about equalizing or offsetting for other assets. The main reason for this is that these accounts are difficult to accurately obtain an exact value before retirement. Many defined benefit plans are based on final pay, rank, or position in a company. Who can accurately predict how quickly or slowly an employee will climb the "career ladder"?

That being said, agreeing to a buyout of a pension plan is common in many divorce cases and will likely continue to be common. I would encourage any party or attorney considering a buyout not only to seek a valuation through a licensed actuary, but also to make sure the client understands how benefits are accrued and the potential monthly income that is being waived by the buyout.

An understanding of the pension plan means knowing if the plan offers Alternate Payee a separate versus shared interest division approach, offers a lump sum payout of Alternate Payee's share directly from the Plan, and what happens in the event of employee's death; i.e., are survivor benefits available to former spouse? These are just a few of the questions that should be discussed for purposes of trying to evaluate a pension buyout as part of a global settlement.

A partial buyout is also within the realm of possibility for purposes of global settlement. Alternate Payee may agree to give up some, but not all, of Alternate Payee's community interest in the Participant's pension plan for a certain sum of money. For purposes of calculating what that buyout scale should be, an actuary should to be hired to convert percentages of future streams of income into present values such that each percentage point Alternate Payee is willing to give up is worth a specific dollar value.

When dividing retirement accounts, if a "creative" proposal is made that deviates from a standard 50-50 split of the community property, it is imperative that the attorney and client understand how that retirement account functions and is valued, before signing off on that division method.

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