Ep #34: Dividing Retirement Accounts in Divorce: QDRO Mistakes to Avoid

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With Your Host

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You're listening to *The Sensible Split* podcast, episode 34. Today, we're talking about QDROs. What the heck are they? Why are they important, and some common mistakes to avoid when QDROs are involved in your divorce.

The Sensible Split is a podcast for smart but overwhelmed women in search of a roadmap to a successful separation and divorce. If you are looking for guidance in navigating the practical, legal, and emotional aspects of divorce with confidence, this is the show for you. Here's your host, Master Certified Life and Divorce Coach, Divorce Attorney, and Mediator, Lauren Fair.

Welcome back. How are you?

We are in the thick of summer at my house. We recently just got back from spending two weeks visiting my family in Pennsylvania. It's really become an annual tradition to spend July 4th there for us. My kids love to help my brother set off fireworks in my mom's backyard. My mom still lives in the same house I grew up in, and it's really nice and cozy to be home. I let my kids set off the fireworks with my brother because my brother's a firefighter and he's super cautious. And they stick to legal fireworks these days, so it's relatively tame, but also very exciting for them.

I got to do some work on the patio with deer coming to visit me in the backyard during the day and lightning bugs at night. It's just really pleasant to be there. Although I will say it was very hot for half the time we were there. It is a level of humidity I am no longer accustomed to. So we had to get creative with activities during the daytime for a while, but thankfully, in the second half of our trip, the humidity kind of lightened up. And during that period of the vacation, my husband joined us, and we visited some new places this trip that we had never visited before, like Fallingwater.

And the day we visited Fallingwater, it poured down rain and was absolutely magical to be there in those conditions. So that's some of what I've been up to this summer. I hope you're having a great summer and finding time for some new adventures, big or small.

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Today, we're going to dive into a fairly dry topic, but an important one that can seriously impact your financial future after your divorce: QDROs, or Qualified Domestic Relations Orders. If retirement accounts are on the table in your divorce, and they usually are, understanding how QDROs work is essential. I'll walk you through what they are, the gist of how they work, when you need one, and how to avoid costly mistakes.

And this is really meant to be informational to help you kind of get a step ahead in thinking about these issues in your divorce, and it is important for you to get legal advice related to your specific situation in the jurisdiction that you're located in.

So first, what is a QDRO? Let's start with the basics. A Qualified Domestic Relations Order, or a QDRO, it's pronounced “qua-dro.” It's Q D R O for short, is a special and separate court order from a divorce judgment that allows one spouse to receive a portion of the other spouse's retirement account without triggering taxes or penalties when done correctly.

So it's designed to achieve a pre-tax rollover of the funds from one qualified plan to another. But it only applies to certain kinds of retirement accounts, specifically those that are governed by ERISA. Oh boy, another acronym, right? ERISA stands for the Employee Retirement Income Security Act of 1974. ERISA is a federal law that sets standards for most private sector employer-sponsored retirement plans. Retirement plans like 401(k)s, 403(b)s, traditional pensions, and profit-sharing plans. These are called qualified plans, and they are divided between spouses in a divorce through the issuance of a QDRO that is accepted by the plan administrator. The plan administrator is the person at the individual retirement plan who is responsible for administering the plan. So it's someone designated by the employer to administer that particular retirement plan. I told you this was dry. Are you with me? We'll try to have some fun with it.

A qualified retirement plan under ERISA is an employer-sponsored retirement savings plan that meets specific federal requirements outlined by both ERISA and the IRS. These requirements ensure the plan is designed to provide retirement income to employees. It offers tax advantages and includes safeguards for participants' benefits.

So, if you've got a plan in your case that is governed by ERISA, and there many, many cases involve these types of retirement plans. Okay, so 401(k)s are one of the most common retirement plan that we see. And again, it can also apply to other forms of retirement plans that are governed under ERISA, but 401(k)s are one of the most common ones that we see come up here. And when you have one such retirement account, you're going to end up needing a QDRO if that account is going to be divided in the divorce.

So a QDRO tells the qualified retirement plan something like, you know, this percentage or dollar amount of the plan is now assigned to the alternate payee. The alternate payee means the ex-spouse, right? The one who is not the employee of the employer-sponsored retirement plan.

So it outlines what is the amount of the benefit under the retirement plan that is going to the non-employee spouse. It ensures that the funds go directly to the spouse who is the non-employee spouse, who is entitled to them without requiring the account holder to withdraw the funds and pay penalties on it.

So you can see how it would be important to have this type of plan in place or this type of order in place for this particular type of plan because you wouldn't want to have the employee spouse just take money out of their retirement to pay their former spouse because if you just take a withdrawal from a pre-tax retirement account, you're going to pay income taxes and penalties on that. As opposed to, when you have a QDRO prepared, that is designed to affect a pre-tax rollover of those funds from the qualified retirement plan over to an account designated by the former spouse or the alternate payee.

So what does that look like in terms of practical application? If you are the non-employee spouse, usually what you would be doing is setting up another retirement plan that is pre-tax to receive a rollover into from the qualified retirement plan. So often times when there's a 401(k) account being divided, then the non-employee spouse's portion of that is rolled over via a QDRO from the 401(k) plan into an IRA that is opened by the non-employee spouse.

So a QDRO is only needed when you're dividing a qualified retirement plan governed by ERISA. You do not need a QDRO for certain types of retirement plans that are not governed by ERISA. An example of a retirement account that is not governed by ERISA is, for example, an IRA. So a traditional or a Roth IRA, SEP IRAs, or simple IRAs, and also government and military pensions. There are special orders that are utilized to divide government and military pensions. They're just not called QDROs. They are oftentimes divided under other types of orders that are called Court Orders Acceptable for Processing, or a COAP, or a Domestic Relations Order, or a DRO, or other plan-specific document.

Again, there's a certain level of complexity to these types of orders. The orders need to be drafted specifically to conform to the terms of the individual plan in your particular situation, and so this can get really technical. And so what exactly it will be called in terms of the order in your specific situation, this is something that you will need to determine with an appropriate professional.

But as an example, if you have a 401(k) at issue, you know you're going to need a QDRO. If you have a Roth IRA, that's not something that needs a QDRO. However, the division must still be done carefully, usually through a direct transfer. So there can be something called an IRA transfer order or provision in a divorce judgment. So one of the most important things you've got to do when you're dividing out retirement benefits is to make sure that you're doing it in a way that avoids unintended tax consequences.

So why do QDROs matter? Why does this matter so much? You may be hearing a lot about QDROs. I find that sometimes clients come to work with me and they've heard about a QDRO, they don't understand what it is oftentimes, and that's to be expected, right? So why does this matter so much?

It's because retirement accounts are often one of the largest assets in a divorce. And if you don't divide them the right way, the consequences can be serious. So a QDRO avoids early withdrawal penalties and income taxes. It ensures the non-employee spouse receives their share directly from the plan administrator, rather than relying on their spouse to pay them their share. It legally obligates the plan to distribute the funds pursuant to whatever the divorce judgment says. The QDRO then takes that information and gives specific instructions to the plan administrator on how to distribute the funds.

So here are some of the biggest QDRO-related mistakes that people make. The first one is waiting too long to have their QDROs done. QDROs come usually at the end of the divorce process, even after the divorce settlement agreement is done. And they can become an afterthought. A lot of the time, by the point that you're at the end of a divorce proceeding, you might be really over it. And when the divorce judgment's done, it's like, okay, yay, I'm divorced. Yeah, I gotta do these QDROs, but I don't really want to do them right now, right? We can do that another day. It costs another fee to the QDRO preparer, which I'll talk about in a minute. And I just really have had enough of this. And we can deal with it another day. Right? Sometimes this is what happens.

Or people just forget, right? They get a letter from an attorney saying, don't forget to do your QDROs, if the attorney is not actively involved in that process. Some are, some aren't. I find there's a difference in approach to that. And perhaps that letter gets lost in the shuffle, and you don't get around to having the QDRO entered. And this is a big mistake.

If the employee leaves the company or rolls the account over to another IRA or another 401(k), the plan may no longer honor the QDRO. Also, if the employee spouse retires and starts drawing on the retirement benefits and there is no QDRO, then they are likely also receiving the share of the benefits that should go to the non-employee spouse. This is a big one. I've been involved in a number of situations where this has occurred, where the QDRO was not done timely, and then the employee retired and they're receiving 100% of the benefits and that, the 100% was not what they were supposed to be receiving under the divorce judgment. And then it creates an enforcement issue, a collection of arrears issue, and potential tax issues as well.

So waiting too long, not a good idea. This is something that you want to address right away while you're doing your divorce judgment or shortly after it is completed. Do not put it off for some future time. Okay?

Number two, not understanding or conforming to the plan rules. So each retirement plan is different. Some are going to require pre-approval of a draft QDRO. Some don't. Some plans don't allow division of certain account features like loans or early retirement bonuses, things of that nature.

So as I said, each plan is going to be different. And a court order or a QDRO cannot tell a plan to do something that the plan rules do not otherwise provide for. So you've got to understand what the rules are. And they're complex, and this isn't something that you really should endeavor to do without some expert input, okay? So it's important to know, though, that these plans are all different, and there are some commonalities across them, but they are all different and you need to have the QDRO drafted in a way that conforms to the terms of the plan.

Number three, having vague divorce settlement language as it relates to retirement division. So if your agreement just says “spouse gets half the retirement account,” right, or something like that, that's not enough. There's got to be specific language around how the non-employee spouse's share is being calculated, whether that includes gains and losses on that amount through the date of distribution, whether there's loans that are going to be included in that calculation or not, etc. You've got to have really specific language in there so that your QDRO process goes as smoothly as it can when you get to that point.

Number four, not working with a QDRO specialist. So, QDROs are technical. Like I said, they require coordination between the legal system and the retirement plan. They're individualized. There are attorneys that focus their practice on nothing but QDROs. So if you or your attorney are not experienced with them, you're going to want to bring in a QDRO expert who can draft the order and guide it through the pre-approval, court filing, and plan acceptance process.

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It is not uncommon for there to be an agreement in a divorce judgment that the parties are going to jointly retain a neutral QDRO preparer. What does that mean? It means that both spouses are going to together retain a third party, usually an attorney, who is going to prepare the QDRO, not an attorney that represents only one spouse, but one that's going to be a neutral just for the purposes of drafting the order that conforms in a way to what the parties agreed to in the divorce judgment. And that they're each going to pay a specified percentage, often 50% of the QDRO preparer's fees. So you want to think about, okay, it costs money to get a QDRO, and so how are we going to share that cost so we don't have unexpected conflict over that when it comes to light that we need to pay for that service.

The good news is that QDROs are often prepared on a flat fee basis. And as of the time of this recording, I have seen that vary between $750 to about $1,250 here locally in California per retirement plan. So that then brings me to number five is not really thinking through fully what the best settlement scenario looks like for you, because it really does cost extra money at the end of the process to be having these QDROs prepared. That being said, in a lot of situations, it's money well spent for the reasons we talked about. Retirement benefits are really valuable assets and important to your future.

However, if you have multiple retirement accounts, then perhaps you do not actually mechanically divide out each one of them, right? Because then you're paying for a QDRO for each of those retirement plans that require one. So that might add a lot of expense at the end. And sometimes that might be necessary, right? That might make the most sense for you. But you want to be thoughtful and intentional about that because there are scenarios where it makes more sense to figure out what each spouse's interest is in each retirement and then offset them in a way where you're only actually mechanically, kind of dividing out one or two of the retirement plans, but still taking into consideration what the overall division of the retirements should look like.

All right, so here's what I recommend if you're dealing with retirement assets in divorce. You're going to want to flag the QDRO issue early. Know whether it's an issue in your case so you can set your expectations accordingly. You can gather the information you need in order to make the best decision about what to do with that retirement account and just kind of understand what's involved in determining your interest in it and seeing it through to the end to division.

Secondly, you want to include clear settlement language in your agreement. You want to work with a QDRO attorney who handles these things regularly, and you want to follow through with getting a QDRO in place in a timely manner. Don't let it fall off the radar. I know you might have some decision and just overall divorce fatigue by the end of the process, but don't let this fall through the cracks.

QDROs may not be the most exciting or interesting part of a divorce, but they are one of the most important, especially if you're counting on retirement security. They ensure that your rights to those assets actually become financial reality. So if you're unsure whether your divorce involves accounts that need a QDRO, or if you're divorced and never filed one, now's the time to ask. Talk to your attorney and make sure you're covered, okay?

Thanks for tuning in today. I'll see you in the next episode.

Thank you so much for tuning in to this episode of *The Sensible Split*. If you're looking for more information and guidance to help you successfully navigate a divorce, please visit TheSensibleSplit.com.

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