

Dividing Retirement Plans in an Unpredictable Economy

Elizabeth Sales, J.D., L.L.M. in Taxation

San Diego Paralegal Association MCLE Event
Getting Back To Basics . . . Divorce
Settlements In A Difficult Economy

March 17, 2009

Overview of a Qualified Domestic Relations Order

- Prior to the Retirement Equity Act of 1984, there was an inherent conflict between IRC Section 401(a)(13) and state domestic court proceedings
- REA created the Qualified Domestic Relations Order so that no order of any state court will effect a transfer of qualified plan benefits to the spouse or former spouse of a plan Participant unless it is a QDRO

- Qualified Domestic Relations Orders are normally prepared and entered after the Marital Settlement Agreement is signed
- California Family Code Section 2337: Use standard language or enter QDRO simultaneously with Marital Settlement Agreement

401(k) and Defined Contribution Plans

- Issue: Loan amount may exceed outstanding balance
- Solution: Determine account balance and loan balance before signing Marital Settlement Agreement so this issue can be resolved
- Determine if loan is community property
- Inquire with plan administrator as to whether distribution can be made despite the loan balance

- ⦿ Issue: Equalizing Payment in Marital Settlement Agreement
- ⦿ Solution: Insert an effective date for the equalizing payment into the Marital Settlement Agreement or state clearly that payment shall not be adjusted for earnings and losses in the 401(k)

Example:

- Husband has 401(k) worth \$40,000 on 1/1/08
- Wife has 401(k) worth \$60,000 on 1/1/08
- MSA says to equalize by payment of \$10,000 from Wife to Husband and Husband shall keep his 401(k)
- MSA is signed 01/01/08
- Wife's 401(k) loses 50% in value in 2008 due to weak economy
- QDRO is not served on plan administrator until 1/1/09
- If no effective date is stated in the MSA, there will be an issue as to whether Husband will receive \$10,000 or \$5,000

- Consider: Is it always appropriate to have an effective date for equalizing payment?
 - > Equalizing 401(k) with Defined Benefit Plan
 - > Equalizing 401(k) with House or other property

- ⦿ Issue: Lack of Liquidity and Inability to Withdraw from 401(k) Plan due to 10% federal penalty and 2.5% California penalty
- ⦿ Solution: Use QDRO to transfer money to an alternate payee to avoid 10% penalty under IRC 72(t)(2)(C)

Example:

- Wife owes debt (i.e., attorneys fees) of \$10,000
- Wife's 401(k) has \$50,000
- Wife's 401(k) is 100% community property
- If Wife were to withdraw her \$25,000 directly from the plan, she would pay:
 - > \$25,000 at 28% federal tax equals: \$7,000
 - > \$25,000 at 9.3% CA tax equals: \$2,325
 - > \$25,000 at 10% federal penalty equals: \$2,500
 - > \$25,000 at 2.5% CA penalty equals: \$625
 - > Total Taxes and Penalties: \$12,450
- Leftover to Pay Debt: \$12,550

- ◎ If instead the funds were assigned to the Alternate Payee, the Alternate Payee would pay only taxes and no penalties:
 - > \$25,000 at 28% federal tax equals: \$7,000
 - > \$25,000 at 9.3% CA tax equals: \$2,325
 - > Total Taxes and Penalties:\$9,325
- ◎ Leftover to Pay Debt: \$15,675
- ◎ Savings by using Alternate Payee: \$3,225

- ◎ Defined Benefit Plan Valuations
- ◎ Risks to Advise Your Clients of Before Agreeing to a Defined Benefit Valuation:
 - › Financial Solvency of the Company
 - › Covered by PBGC?
 - › Interest Rates
 - › Inflation
 - › Life Expectancy Tables

Case Law: Kennedy v. Plan Administrator for DuPont Savings and Investment Plan, No. 08-636

January 26, 2009

- Husband had a retirement plan
- Husband and Wife divorced and MSA awarded all benefits in plan to Husband
- Husband forgot to change his beneficiary designation form and form still named Wife
- Husband died
- Despite the MSA, the plan paid the benefits to the Wife
- Supreme Court said the plan is only responsible to look to the papers it has on file, and not the MSA
- Lesson: Advise clients to check their beneficiary designation forms because an MSA will not divest the benefits to the beneficiary

Case Law: *Owens v. Automotive Machinists Pension Trust*, 9th Cir., No. 07-35253

January 12, 2009

- ◉ Washington state domestic law defines a quasi marriage
- ◉ Norma Owens maintained a “quasi marital” relationship with Phillip Owens
- ◉ State court ordered that Norma was to receive 50% of the retirement benefits
- ◉ Plan administrator would not accept the QDRO because it did not relate to “marital property rights”
- ◉ Ninth Circuit held that Norma could be paid out as an alternate payee because she was an “other dependent” because they shared a home and she cared for Phillip and his children

Questions and Answers