How Does a Participant's Divorce Affect our 401(k) Plan?

Facts

One of the participants in our 401(k) plan is going through a divorce, and we just received a court order directing us to provide a portion of his account to his ex-spouse. I thought that retirement plan accounts had special protection against legal judgements.

Question

Are we supposed to act on this court order? If so, what are we supposed to do?

Answer

For starters, you are correct that retirement plans enjoy special protections against creditors and legal judgements; however, there is a very narrow exception that can come into play in domestic relations situations, primarily divorce proceedings.

The order that you received is most likely what is called a Domestic Relations Order (DRO). If a DRO meets certain requirements, it becomes a Qualified DRO or QDRO and is a mechanism the courts can use to divide martial property as part of divorce proceedings.

In order to be qualified, a DRO must include the following information:

- Name of the plan to which the order relates,
- Name of the participant,
- Name of the alternate payee (the person receiving the benefits from the participant),
- Amount of the award (either as a dollar amount or formula such as a percentage of the participant's account balance as of a certain date), and
- Specific notation that the order is issued pursuant to state domestic relations laws.

The DRO cannot provide a greater amount than what the participant is entitled to receive, and it cannot conflict with plan provisions regarding the manner in which the benefit is paid. For example, if the plan does not permit annuity payments, the DRO cannot award an annuity to the alternate payee.

All plans are required to have written procedures for processing QDROs, so it is important to familiarize yourself with your plan's specific requirements before taking action. With that said, here are the general steps involved.

1. Freeze the participant's account for distribution and loan transactions. This is to ensure the participant doesn't take his/her money and run as a way to prevent the former spouse from receiving anything.
2. Notify the participant and alternate payee that either you have received or expect to receive a DRO and have frozen the account accordingly.
3. Review the content and details of the DRO to confirm that it includes the necessary information to be qualified.
4. Notify the participant and alternate payee that either the DRO is a Qualified DRO (QDRO) or provide details of any necessary revisions.

5. Upon determining the DRO is qualified, work with your recordkeeper to split the account as directed by the QDRO.

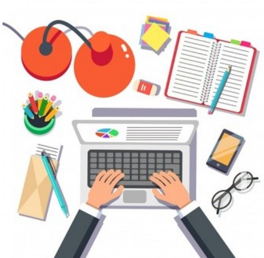
It is important to note that courts tend to enforce QDROs exactly as they are written. That means it is critical not to try to read between the lines to infer what is contemplated. One example might be an order that awards 50% of the participant's account balance as of the first day of the year. If the order is not processed until, say, October 1st of that year, it might be tempting to adjust the award for any investment changes during the intervening nine months. However, unless the order specifically calls for an earnings adjustment, that should not be done.

Once the account has been split, the alternate payee is essentially treated the same way as a former participant who still has a balance in the plan. If the balance is more than $5,000, the alternate payee can keep his or her account in the plan. Conversely, if the balance is below $5,000 (or whatever your plan's mandatory distribution threshold is), you can force him/her to take a distribution after providing the requisite notices. Speaking of notices, as long as the alternate payee's balance remains in the plan, s/he must continue to receive all of the same notices that other former employees with balances receive, including the Summary Annual Report, fee disclosures, and any blackout notices that might apply.

Seeing a court order related to a participant's divorce land on your desk or in your inbox can be a bit unsettling. However, as long as you follow the terms of the order and your plan's QDRO policy carefully, they can generally be dealt with quickly and easily. Of course, if you have questions, pick up the phone and call your friends here at DWC. We can help you work through any questions you might have.

Related Resources

- Qualified Domestic Relations Orders: Don't Let the QDRO Be Worse Than the Marriage
- Can We Split QDRO Fees Between Participant and Ex-Spouse?



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