

# QDRO CREATIVITY

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# QDRO CREATIVITY

By Garrick G. Zielinski, CFP, CDFA

**Discovery, analysis and evaluation should be completed before the negotiation and drafting begins.**

It is important to first to determine what type of Plan it is. Most private sector retirement vehicles are either Individual Retirement Arrangements (IRAs), defined contribution (DC) plans, or defined benefit (DB) plans. The Employee Retirement Income Security Act (ERISA) of 1974 governs DC and DB Plans. The Retirement Equity Act (REA) of 1984 was enacted to resolve the growing conflict between ERISA and state law allowing for distribution of retirement rights in DC and DB plans upon dissolution of marriage. REA added I.R.C. § 414(p) which permits the creation, assignment and recognition of any right within DC and DB plans of a participant only through a Qualified Domestic Relations Order (QDRO). IRA's are not qualified plans as defined by ERISA. Instead, IRA's come under the provisions of IRC § 408. Thus to transfer funds tax free<sup>1</sup> from an IRA to a spouse or former spouse, a QDRO is not required nor are the QDRO rules applicable.

An IRA is the most basic sort of retirement arrangement. Most people tend to think of an IRA as something that individuals establish on their own. However, there are three plans that businesses can sponsor and help their employees to fund their IRA's. With an IRA the amount that an individual receives at retirement depends on the funding of the IRA and the earnings or losses on those funds. I.R.C. § 1041 is not applicable to transfers of funds from IRA's as it was never intended that I.R.C. § 1041 would override the provisions of I.R.C. § 408(d) applicable to IRA's which predated the adoption of the provisions of I.R.C. §

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<sup>1</sup> I.R.C. § 408(d)(6)

1041. Company sponsored IRA's are typically referred to as SAR-SEP, SIMPLE IRA and SEP-IRA Plans.

A plan that is expected to pay a monthly benefit at a certain retirement age, in most cases, based on a formula using the participant's length of service and/or salary is a defined benefit plan. While a participant is employed, sufficient actuarial calculated contributions are made by the employer to generate the defined monthly retirement benefit payable to the participant in the future. In essence, the retirees "benefit" in a defined benefit plan is "defined" or known in advance, and the contributions needed to provide the benefit are not defined. Usually there are no individual account balances within a defined benefit plan. Defined benefit plans are typically referred to as pension plans, retirement plans or benefit plans.

A plan that defines the contributions while a participant is employed, with the future value of the benefits left uncertain, is a defined contribution plan. In essence, the "contribution" in a defined contribution plan is "defined" or known and the final benefits payable are not defined. The defined contribution plan may contain individual account balances for each participant, which are valued at least once each year. Defined contribution plans are typically referred to as 401(k) plans, profit sharing plans, employee stock ownership plans (ESOP), money purchase, Keogh plans and savings plans. Many defined contribution plans may contain sub-accounts such as employer contributions, employee contributions, employer matching contributions, and pre-tax/after-tax contributions.

### **What Can a QDRO Do?**

A QDRO may be used to provide survivorship benefits to the former spouse. It could be drafted to provide an early retirement provision thereby allowing the former spouse an opportunity to collect her benefits independent of the commencement of the participant. It is usually drafted in the context of a

property settlement but it can also be used to provide child support (current and arrears), maintenance (current and arrears) or to satisfy marital property rights. A QDRO can facilitate a distribution from a qualified plan and the proceeds could be used for a myriad of purposes, such as debt reduction, or a down payment on a residence. In a New York Supreme Court case<sup>2</sup>the court not only ordered distributions from a profit sharing plan to pay child support and other arrears, the court also ordered that attorney fees in arrears, plus attorney fees for the current proceeding be paid from the plan distribution in addition to \$41,000 for income taxes which were a result of the distributions.

### **What Can't a QDRO Do?**

Since the QDRO is the document that divides the retirement benefits, it is imperative that you understand the type of plan, the plan benefits, the available methods of distribution options and the required procedures necessary to obtain the benefits prior to drafting, negotiating and filing the QDRO. ERISA and IRC § 414(p) lists the following three restrictions on QDRO's:

The order cannot require the plan to provide any type or form of benefits, or any option, not otherwise provided under the plan<sup>3</sup>

The order cannot require the plan to provide increased benefits determined on an actuarial value<sup>4</sup>.

The order cannot require the payment of benefits to an alternate payee that are already required to be paid to another alternate payee under a previous order<sup>5</sup>.

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<sup>2</sup> See Renner v. Blatte, 650 N.Y.S.2d 943 (N.Y. Supp. Oct. 18, 1996)

<sup>3</sup> IRC § 414(p)(3)(A) and ERISA § 206(d)(3)(D)(i)

<sup>4</sup> IRC § 414(p)(3)(B) and ERISA § 206(d)(3)(D)(ii)

<sup>5</sup> IRC § 414(p)(3)(C) and ERISA § 206(d)(3)(D)(iii)

## **Conducting a Preliminary Valuation**

The importance of valuing retirement benefits for divorce cannot be overemphasized. Viewed as an asset, the value of a retirement plan can, in many cases, constitute the single largest marital asset. There are certain assumptions made and tables used, which when altered, can significantly change the final value of a participant's retirement plan.

Defined contribution plans have the least amount of valuation issues while defined benefit plans have the greatest number of issues. On occasion a participant wishes to keep his entire interest in his retirement plan, and in exchange, the non-participant former spouse will retain the equivalent value in other marital property, such as investment accounts, equity in the home, vehicles, etc. Often this can be an efficient and cost effective means of assigning half of the value of the plan to the non-participant former spouse, especially if the value is not very large.

There are different accepted methods of determining the present value of a defined benefit retirement plan. Different methods of determining the present value of a retirement plan will yield surprisingly different results. An "economic" present value calculation uses different assumptions than an "actuarial" present value calculation.

The interest or discount rate is one assumption that differs between the two methods. Typically an actuary will rely on a tiered interest rate structure using rates published by the Pension Benefit Guarantee Corporation (PBGC). The rate structure that the PBGC produces has, in effect, an insurance premium or guarantee built into these rates, which are paid by the employer in calculating the employer's pension liability. An insurance premium is not necessary in the case

of determining the value of a monthly benefit to an individual. The cost of the plan to the employer, is not the same as the fair value to the employee.

An economic present value calculation will usually use an interest rate that is based on the U.S. Treasury Bond Yield, for example. U.S. Treasuries are the most creditworthy of all debt instruments since they are backed by the "full faith and credit" of the U.S. Government. Using Treasuries as a barometer is considered the risk-free rate, meaning the minimum rate of return an individual can expect when considering all other types of investments.

Life expectancy of a participant based on gender and race is another important element to consider. The United States life tables and national vital statistics reports, described in another section of the outline, are excellent sources for estimating the reasonable life expectancy of an individual. Be aware of actuarial present value calculations that may consider life expectancies well over 100 years of age, as their assumptions tend to mimic those of an employer seeking to conservatively calculate its liability to fund a pension plan.

In determining the present value of a retirement benefit for purposes of a property offset or buy-out against other post-tax marital property, it is important to use assumptions that are suitable and logical in regard to the divorcing party. The assumptions used in an economic present value calculation are more appropriately geared towards a real life situation rather than a book of numbers.

A present value of a pension<sup>6</sup> calculation has 5 basic factors, 2 of which are assumed, which directly affect the final present value. These are (1) duration of the payout period based on life expectancy, (2) mortality, (3) dollar amount of benefit, (4) the participant's tax bracket, and (5) the assumed interest rate. These factors become a chain of assumptions upon which the calculation of the present value is supported by the weakest link.

A key relationship is that the longer the payout period, the higher the present value. The duration or payout period is based on 3 factors: The participant's age, the normal retirement age and the life expectancy.

Another approach is to look for the “**control point**” in a pension. It is pure speculation as to when the participant will actually retire. However, the age at which the participant has the absolute and non-forfeitable right to retire is certain. Therefore, have the pension valued at the earliest possible retirement age.

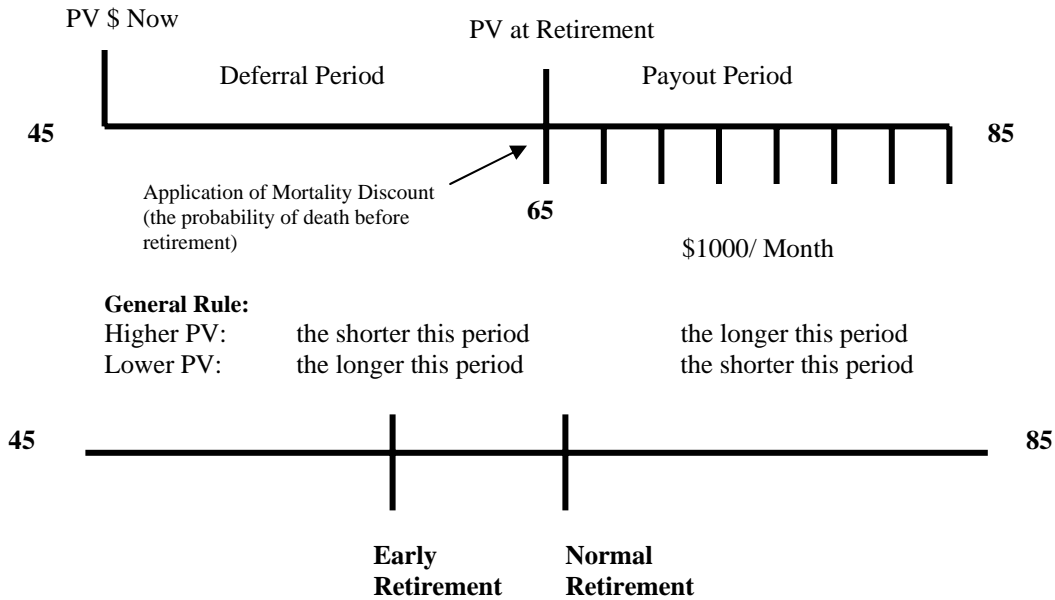
A **mortality discount** is used to take into account the probability that the participant will de cease prior to commencing his or her pension. Pensions are promises of future benefits, unlike a defined contribution plan. Under a pension you are promised a benefit at a future date but one of the requirements is that you live until that date. Under many plans a single participant will forfeit his or her promised retirement benefit if they die prematurely.

A key relationship for the attorney to understand is that the longer the duration or payout period, the higher the present value of a pension. The duration is based on three factors: (See Appendix E)

- a. the participant's present age
- b. the participant's assumed retirement age
- c. the participant's life expectancy

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<sup>6</sup> See *Steinke v. Steinke* 126 Wis. 2d 372, 376 N.W.2d 839 (1985)



Once understood, the relationship between short and long payout periods becomes obvious. The longer the payout period the greater the present value.

The Plan Administrator usually provides the monthly benefit that is used to calculate a pension valuation. It would be wise to ascertain the last valuation of the accrued benefit. Many plans can be as long as 18-months in arrears with updating their actuarial calculations. You may consider doing your own calculations by seeking a copy of the Plan Document.

The **tax discount**<sup>7</sup> may possibly be the most debatable assumption used in the valuation process, next to the assumed interest rate. The common question is what tax bracket is the participant in now, or likely to be in during retirement? Here is where the question of certainty comes up again. If one thing is for certain, we know that tax rates and tax laws will continue to change in future years. A rule of thumb currently being employed by many evaluators is to simply discount the present value by 20%, the same discount rate used to withhold on distributions from qualified plans<sup>8</sup> unless a more suitable<sup>9</sup> tax discount rate can be ascertained.

<sup>7</sup> See Corliss v. Corliss 107 Wis. 2d 338, 320 N.W.2d 219 (Ct. App. 1982)

<sup>8</sup> I.R.C. § 3405©(1)(B) and (e)(1)(A)(I)

<sup>9</sup> See Laribee v. Laribee 138 Wis. 2d 46, 405 N.W.2d 679 (Ct. App. 1987)

The **interest rate** assumption<sup>10</sup> used to value a pension is without question the most critical of all the previous mentioned assumptions. The single most important mathematical relationship to know and understand is the lower the assumed interest rate used in the calculation, the higher the present value. Conversely, the higher the rate used, the lower the present value. For example, if a pension promises to pay \$1000 per month for 10 years the present value is \$98,770 using a 4% discount rate, whereas the present value is \$78,942 using a 9% rate. These are the lump sums needed, based on the discount rate used, to provide \$1000 per month for 10 years. The inverse relationship between interest rates and present value results from the fact that at a lower interest rate assumption, a larger lump sum of money would be required to provide the same monthly income over the specified period of time.

Other valuation issues may include vesting, cost of living adjustments (COLA), coverture fraction formulas, shortened life expectancy, and larger tax discounts.

The common threads, which flow through different pension valuations, have, in a comparative sense, varying effects on the present value outcome simply because of the methods and sources used. One thing is for certain, the relationships of interest rates to the present value or duration to the present value are mathematical truisms, which are only modified or distorted by the methods of valuation employed.

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<sup>10</sup> See *Bouchard v. Bouchard* 107 Wis. 2d 632, 321 N.W.2d 330 (Ct. App. 1982)

<u>FACTORS AND ASSUMPTIONS</u>	<u>AFFECT ON PRESENT VALUE</u>
High Interest Rate	Lower Present Value
Low Interest Rate	Higher Present Value
Early Retirement Age	Higher Present Value
Normal Retirement Age	Lower Present Value
Shortened Life Expectancy	Lower Present Value
Cost of Living Adjustment	Higher Present Value
Marriage Coverture adjustment	Lower Present Value
Larger Tax Discount	Lower Present Value

**PRACTICE TIP:** If you’re looking to free up some cash in a dissolution case and the parties have substantial “rollover” IRA accounts from a previous employer plan consider transferring the rollover IRA to a company sponsored retirement plan that allows such contributions and then divide the plan with a QDRO that requires an immediate distribution.

**PRACTICE TIP:** Determine the factual rights of the participant under the plan as it relates to the sub-accounts. For example, many plans allow in-service distributions from one sub-account and not the other. It might be appropriate to single out a certain sub-account to assign to an alternate payee. An example might be to require a 100% award of the “after tax” portion of the plan and require an immediate distribution. The proceeds of which could be used to pay attorneys fees and reduce consumer debt, for example. In addition, if the plan allows for “in service withdrawals” it may not be necessary to draft a QDRO in order to resolve some financial issues or divide the pension.

### **Joint and Survivor Benefits**

**How do you secure survivor benefits for a non-participant spouse without naming them as the surviving spouse?**

A QDRO may designate an alternate payee as the joint and survivor for pre-retirement and post-retirement benefits whether or not the QDRO is a “Separate Interest” QDRO or a Shared Interest QDRO. However, a plan that is already in pay status, may have limited or irrevocable benefits in place. Particular to ERISA plans, and regardless of the circumstances, the joint and survivor option previously elected may not be changed, even by a court order. However, there are a few plans we are aware of, particularly WRS and many other state teacher’s plans, where options already in pay status may be altered and changed after the date of divorce.

There are three methods to securing a joint and survivor protection for your alternate payee. The first method would be to provide the alternate payee with a “Separate Interest” QDRO that specifically states that the participant’s death will not affect benefits payable to the alternate payee. The second method is to specifically name the alternate payee as the surviving spouse for both pre and post retirement survivor benefits. The third method is a combination of the previous two methods in that a Separate Interest QDRO is drafted and the alternate payee is named as the surviving spouse to any pre-retirement surviving annuity and/or a post retirement survivor annuity. Please note that the latter method may eliminate the participant’s ability to name a subsequent spouse as the surviving spouse to future accrued benefits.

Under a “Separate Interest” QDRO it is acceptable to allow the alternate payee to name a beneficiary under an optional form of payment. Such optional form of payment could be in the form of 60 payments certain and life form, for example. The Retirement Equity Act of 1984 (REA) contains an example in which the alternate payee elected a 60-month certain and life annuity payment and designated her son as the beneficiary to the remaining payments if she did not survive the 60 months. Our opinion is that under the payment certain option, you may elect anyone, including a subsequent spouse, to collect the remaining unpaid benefits. In the REA example, however, the “child” constitutes an “allowable”

alternate payee under the statutory definition. If the alternate payee chooses a beneficiary that is not defined as an alternate payee, it could be easily argued by the plan that the designation does not satisfy the statute requirements. For certain, the statute is clear that an option of a “joint and survivor” annuity is not allowable with a subsequent spouse. The difference of course is that one form of benefit is paid over the lifetimes of the spouse and former spouse while a period certain is a finite payment. The impact on the benefits paid is also altered in the event of an election of a joint and survivor annuity.

Furthermore, assume that the QDRO requires that the former spouse is to be named the surviving spouse for purposes of the survivor benefit paid and the language is very general. The participant may be prevented from naming a subsequent spouse or another beneficiary without first obtaining the consent of the former spouse alternate payee.

Whether to use the Separate Interest QDRO or the Shared Interest method when dealing with the survivor benefit issue depends upon each case. However it is clear that most “model QDRO’s” take a conservative approach and opt for naming the alternate payee as the surviving spouse.

What about a situation where the plan is in pay status and the participant previously elected a survivor option, thus reducing his monthly benefit in the process? Does the survivor benefit option have a present value? A recent Court of Appeals case<sup>11</sup> absolutely confirms that it does. At the time of divorce the husband had been receiving a pension and social security in the amount of \$3,451 per month. The wife was still working as a teacher and earning \$2,833 per month. The court eventually got around to treating the pension as income rather than an asset. The court also recognized that the survivor benefit is a marital asset but did not include the \$52,000 value of the survivor option in a division of the marital property. In short, the court decided that since the pension was treated as income,

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<sup>11</sup> See Cir. Ct. No. 01FA004940 Appeal No. 03-1140

and there was no assurance that the survivor would ever collect the benefit, the survivor option was simply a derivative of that income. Had the pension been treated as property, the survivor benefit would have also been property.

The author recently finished a case in Kenosha County with nearly the exact same circumstances. However, the husband participant was 65 years old and the non-participant wife was 50 years old and they were married a relatively short 12 years. Nearly 80% of the pension was accrued prior to the date of marriage. Nonetheless, in a conference with counsel, Judge Wagner indicated that she would treat the entire pension as income and the survivor benefit as an asset. The author believes the largest factor in this case was the age discrepancy and that the wife was *likely* to collect on this survivor benefit.

Also see Court of Appeals case No. 98-2905-FT Johnson v. Johnson. This case also involves a pension that is in pay status. However, Northwest Airlines in this circumstance provided a 50% survivor option to the husband at no additional cost due to his disability. The husband appealed that the court erred in not valuing the survivor benefit but the court affirmed. However, the court stated “We do not mean to indicate, however, that had husband and wife selected reduced benefits so as to assure the wife continuing pension benefits in the event of husband’s death, that this would not be a proper factor for the court to consider in ordering the distribution of the pension benefits.”

**PRACTICE TIP:** The survivor benefit issue is a separate issue<sup>12</sup>. It is allowable to fully divide the entire accrued survivor benefit as of the date of death for example, and then divide the accrued benefit as of the date of divorce. Therefore, the parties may negotiate the survivor benefit issue independent from the division of the marital portion of the retirement benefit.

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<sup>12</sup> See Herdt v. Herdt 152 Wis. 2d 17, 447 N.W.2d 66 (Ct. App. 1989) Civil Service survivor benefits

## **Retirement Age and Survivor Benefits**

It is important for the attorney to ascertain the earliest retirement age under the plan that is being divided via QDRO. Most defined benefit plans provide early retirement at the participant's attainment of age 55. However some plans define the earliest retirement age as a function of the number of years of service or age plus years of service. Benefits paid sooner than the normal retirement age are subject to reduction for early commencement. For example, if a participant has earned a benefit equal to \$1,000 per month payable at age 65, he may be allowed to receive it early, at age 55, in reduced form, such as \$500 per month. The accrued benefit is reduced to compensate for the extended payout period.

In a standard defined benefit plan, benefits are not payable to an alternate payee until the participant attains the earliest retirement age under the plan. While the age of the alternate payee may impact the amount of benefit she receives under an independent interest QDRO, it has no impact on her ability to commence receipt of benefits.

Compare the age of the participant to the age of the alternate payee. Determine the earliest retirement age of the participant, which is the point at which benefits are payable to the alternate payee. If there is a large discrepancy in age between the alternate payee and the participant, it is possible that the awarded benefit will never become payable to an alternate payee. In some instances it is worthwhile to explore creative and cost effective solutions to the variety of problems that may be encountered.

For example, assume that you have a 60-year-old male participant that has accrued a vested lifetime benefit equal to \$2,000 per month. Assume the alternate payee is age 50, and she is awarded 50% of his benefit, or \$1,000 per month. If the alternate payee is to receive benefits in the amount of \$1,000 per month, they will be based on the participant's lifetime and will cease upon his death, often

referred to as “if, as and when” type QDRO’s. If benefits are to be paid to the alternate payee over her lifetime, which is most often the intent, then the amount she receives must be actuarially converted to accommodate her age and life expectancy under the terms of the plan. Given the age difference between the parties in this example, a benefit of \$1,000 payable for the lifetime of the participant may only yield \$350 per month for the lifetime of the alternate payee. This is because the alternate payee is younger, expected to live longer, and thus receive payments over a longer period of time.

**PRACTICE TIP:** Further assume that the plan allows for a 100% joint and survivor annuity equal to \$1,600 per month payable over the lifetimes of both the participant and his former spouse. The 100% joint and survivor annuity is less than the option that would provide the participant with a monthly benefit for his lifetime alone because it is reduced by the costs associated with paying the benefit out over the lifetimes of two individuals. A shared interest QDRO could require benefits to be paid in the form of a 100% joint and survivor annuity, with the alternate payee deemed the “surviving spouse”. The QDRO could for example, award the participant \$1,200 per month (which is more than 50% of the accrued \$2,000 he would have received with a straight 50/50 division) and the former spouse \$400 per month (which is more than the actuarial equivalent she would have received under an independent interest QDRO). At the participant’s death, which is likely to be substantially earlier than the alternate payee’s in this example, the alternate payee would receive \$1,600 per month until her death (which is substantially greater than what would otherwise be payable to her under an independent interest QDRO). This example demonstrates how analyzing the spousal benefits in each particular marital situation could provide increased value to each party and potentially solve a myriad of other financial issues.

The closer a person is to retirement, the larger the present value. The value of the pension peaks at the retirement date. This makes sense when you consider that with any length of a deferral period, that the plan, or individual saving for

retirement has time to let the funds compound at interest. At retirement, the fund is no longer growing and must then be annuitized or liquidated to pay out the desired monthly benefit. As each year passes subsequent to the retirement date, less and less money is needed in the form of a lump sum to provide the required income over the remaining payout period.

Understanding how each of these elements of a present value calculation relate to the final value of the plan, whether the attorney represents the participant or the participant's spouse, will only strengthen the attorney's ability to negotiate a fair settlement on behalf of their client.

### **Plans with Special Issues**

The bifurcation of retirement plans under Government sponsored plans, church plans, tax exempt organizations and foreign plans are generally not subject to ERISA and therefore may be very difficult to deal with. However, today § 403(b) and § 457(b) plans are subject to the QDRO rules. Also tax exempt organizations may now sponsor 401(k) plans.

Federal Government (non-military) orders are called Qualified Court Orders and are not subject to the QDRO rules and ERISA. The rules for Civil Service Retirement System (CSRS) and the Federal Retirement System (FERS) are found at 5 CFR §838.211(a)(30) and 5 CFR §838.621 (a) subparts C and F.

Generally under CSRS and FERS a former spouse (not referred to as alternate payee) may not receive a portion of an employee annuity before the employee annuity is paid to the employee. Also, the Government will only accept an order that reflects a certain type of formula and/or share of an employee's annuity. It may be expressed in a fixed dollar amount, a percentage or fraction, a formula set forth by statute<sup>13</sup> or a pro rata share using a coverture fraction formula which is

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<sup>13</sup> See 5 CFR §838.305(b)(1)

specific to 5 CFR §838.621(a). Survivor benefit options are also unique. If the non-participant spouse remarries prior to his/her age 55, survivor benefits awarded in the Qualifying Court Order are automatically voided.

Military Plans are governed under the Uniformed Services Former Spouses' Protection Act (USFSPA) which is the government's version of ERISA regarding divorce and division for governmental plans. Preparing a Military plan or qualified court order is similar to a QDRO for an ERISA type plan. Military plans however, have a number of unique features that you should be made aware of. The order must allocate the benefits as either a percentage of disposable retired pay<sup>14</sup> or retainer pay or as a flat dollar amount. The Military specifically prohibits the use of a formula or coverture fraction formula method to divide benefits. In either event, under these circumstances it makes it extremely difficult to provide a fair and equitable division. There are some creative options that can make it much easier to divide the benefits equitably. For example, the state court could retain jurisdiction and modify the terms of the order at the time of benefit commencement for example. In that manner, the order could be modified at retirement age using a flat dollar amount or percentage based on a formula set forth in the marital settlement agreement.

Survivor benefits can only be awarded to one spouse. Therefore, if the Military Order requires the member to elect a survivor benefit option for a former spouse, he/she is not allowed to elect a survivor benefit for a subsequent spouse.

Each church plan has its own terms and conditions in regard to rules, which define the division of the plan assets incident to a court order. Although a church plan is generally not covered by ERISA, a plan may choose to be governed by ERISA. In the author's experience he has never come across a church plan that is governed by ERISA. Rightly so, why would the plan want to be burdened by a pile of red tape when they are not required to do so?

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<sup>14</sup> See *Loveland v. Loveland* 147 Wis. 2d 605, 433 N.W.2d 625 (Ct. App. 1988)

## **Determining the Impact of Inflation**

If a plan contains either a specified or unspecified cost of living adjustment (COLA) clause, an inflation adjusted interest rate should be applied to the present value calculation. Most, not all, ERISA plans don't contain COLA's. Most, but not all, government including City, State and Federal plans contain a cost of living clause. Wisconsin Retirement System does not contain a COLA clause. What it has is a "benefit adjustment" based upon investment results. Therefore no COLA is specified but the plan has averaged an increase near 6% annually over the last 15 years. The plan may provide a COLA but the rate is unspecified. The plan document may contain language that uses a benchmark rate such as the Consumer Price Index as the rate.

Assigning an alternate payee an exact dollar amount per month from a defined benefit<sup>15</sup> plan will produce that stated dollar amount, which the plan pays at a certain date, such as the date the participant attains age 65. However, the actual date of the alternate payee's application for benefits may provide for a different dollar amount. For example, if the alternate payee is awarded \$500 based upon the participant's age 65 benefit, the alternate payee would receive \$500 per month at the participant's age 65 and the benefit would stop at the participant's death if the alternate payee were not deemed the "surviving spouse"<sup>16</sup>. If the alternate payee were to commence her benefit at any other time, the benefit would be adjusted actuarially. Awarding an exact dollar amount may restrict the alternate payee from participating in future service credits, subsidies, and cost of living or benefit enhancements, unless specifically awarded.

## **Using a Percentage Division**

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<sup>15</sup> I.R.C. § 414(p)(2)(A)(B)(C)(D)

<sup>16</sup> I.R.C. § 414(p)(5)(A)(B)

Often the marital settlement agreement will assign an alternate payee a certain percentage of the participant's retirement benefits, without any specification as to the effective date of the award, and whether or not survivor benefits are awarded. A percentage award is acceptable, however specification of the effective date of the award is recommended. Such date may be expressed as of the date of divorce, as of the valuation date closest to the date of divorce or it could also be determined as of the date of commencement of the benefit as an example. If no date is specified and the Plan "qualifies the order" it is likely that the percentage will apply upon *application* for benefits.

Using language such as "the alternate payee is awarded 50% of the accrued benefit of the participant calculated as of the date of divorce" could yield surprisingly different results between administrators. If the plan uses a formula based upon the number of years of service and average annual salary the alternate payee will likely not participate in future service credits and/or plan enhancements and inflationary protections. But what about a plan that accrues in a linear fashion such as Union type plans. From time to time the Union negotiates increases to the formula and the increased formula is applied to all service credits, even those credits earned prior to the increase. Is the alternate payee then entitled to a benefit increase? This depends upon the plan administrator's interpretation of your QDRO.

**PRACTICE TIP:** It is a good idea to seek a benefit determination from the plan administrator not just an approval of the QDRO. In other words, when you are getting your order pre-approved by the plan administrator, ask them to calculate the alternate payee's benefit based upon their interpretation of the QDRO.

#### **Marriage Coverture Formula:**

This is one of the most misunderstood methods of dividing a pension. In the Journal of Forensic Economics, Volume IV, Winter, 1990, pp. 47-54, the author

Ralph A. Frasca points out four coverture methods of dividing pensions. Using a fraction formula to divide retirement plan benefits is popular in many states. A fraction formula can be designed to exclude from division any benefits attributable to a participant's service *prior to* the marriage. Alternatively, it can be designed to include a proportionate share of increases due to higher salaries earned by the participant, and benefit improvements made by the plan for inflation or possibly through collective bargaining negotiation, *after the date of divorce*. A fraction formula is commonly referred to as a marriage coverture adjustment, or a time formula. An example to assign one half of the "marital portion" of a participant's retirement benefits may look like this:

$$\begin{array}{r}
 \text{Number of months of} \\
 \text{Participant's creditable} \\
 \text{service accrued as of the date} \\
 \text{of divorce (or during} \\
 \text{marriage)} \\
 \hline
 \text{Total number of months of} \\
 \text{Participant's creditable} \\
 \text{service at the earlier of} \\
 \text{Participant's retirement or} \\
 \text{Alternate Payee's application} \\
 \text{for benefit commencement}
 \end{array}
 \times 100
 = \text{Alternate Payee's} \\
 \text{percent of} \\
 \begin{array}{r}
 \text{Total retirement} \\
 \text{benefit earned} \\
 \text{As of the earlier of} \\
 \text{Participant's retirement} \\
 \text{or} \\
 \text{Alternate Payee's} \\
 \text{application} \\
 \text{For benefit} \\
 \text{commencement}
 \end{array}$$

Pension benefits may accrue linear to a participant such as the trades and many Union plans. Most however accrue exponentially through the use of a formula benefit defined by a participant's average annual salary and the number of years of service at retirement. Using the linear method, a plan may provide a benefit expressed as \$55 per month for each year of service. Therefore after 30 years of

service a participant has accrued a benefit of \$1100 per month. What happens when the plan increases the \$55 threshold to \$75 per month for example? Using the new \$75 threshold equates to an accrued benefit of \$1500 per month. Under this scenario would the alternate payee receive \$550 per month (50% of the accrued benefit as of the date of divorce) or would the alternate payee receive \$750 per month (50% of the accrued benefit as of the date of retirement). It all depends on the language or formula used in the QDRO. Keep in mind that the plan applies the new formula to all the years of service, even those accrued prior to the date of divorce.

EXAMPLE 1) Using a fraction formula incorrectly can produce startling results that may or may not have been intended. As an example, let's assume that we have a husband participant age 45 and a non-participant wife also age 45. The husband has 20 years of service and for illustrative purposes all 20 years of service overlap with the number of years of marriage.

The husband's employer uses a typical benefit formula to determine a benefit at age 65. They use the average high three-year compensation, times 2%, times the number of years of participation in the plan. The husband earns \$60,000 annually as of the date of divorce and for this example we will assume his high three average is also \$60,000. Therefore, the husband's accrued retirement benefit payable at his age 65 is calculated as follows:

$$(\$60,000 \times 2\%) \quad \times \quad 20 \text{ years} = \$24,000 \text{ per year or } \$2,000 \text{ per month}$$

Let's assume a fraction that calculates the benefit as of the date of divorce. Let's further assume that the husband terminates his employment as of the date of divorce. The numerator under the fractional method is 20 and it never changes because it represents the number of years of marriage. The denominator in this example is also 20 years, which represents the total number of years of service.

Under these facts, the fractional method yields a \$1000 per month benefit payable to the wife. The amount would be actuarially adjusted to reflect the wife's age and gender.

EXAMPLE 2) Using the same assumption as above except that the husband continues to work until age 65. Further assume that the calculation used determines the benefit at retirement rather than the date of divorce. Further assume that the husband now has an average annual salary of \$120,000 per year. The formula then looks like this:

$(\$120,000 \times 2\%) \times 40 \text{ years of service} = \$96,000 \text{ per year or } \$8,000 \text{ per month}$

Under these facts, the fractional method yields a \$2000 per month benefit payable to the wife. The amount would be actuarially adjusted to reflect the wife's age and gender. Under this scenario the parties were actually married for 20 years out of the 40 years of service or 50% of the husband's working career. Yet, the husband accrued 75% of the calculated benefit after the date of divorce.

EXAMPLE 3) Using the same facts as above except that the husband's average annual income does not change yields yet a different result:

$(\$60,000 \times 2\%) \times 40 \text{ years of service} = \$48,000 \text{ per year or } \$4,000 \text{ per month}$

Under these facts, the fractional method yields a \$1000 per month benefit payable to the wife, the same amount as in the first example. The amount would be actuarially adjusted to reflect the wife's age and gender.

A marriage coverture formula is often advantageous to the alternate payee because it may allow him/her to participate in future service credits, enhancements and entitlements under the plan. The largest increase in benefit accrual will normally occur in the final five or ten years of service. When used for this purpose, the benefit paid to the alternate payee is determined at the time of application for benefits rather than the date of divorce. Most plans pay a benefit based on the number of years of service multiplied by a formula using the "final average earnings" method. As a result, this will dramatically increase the final benefit. When the QDRO requires the plan to provide a benefit payable to an alternate payee based upon the final benefit payable to the participant, it will generally be a division of the greatest benefit payable. This is an excellent negotiating tool for the alternate payee to provide the maximum benefit determined on the number of years of marriage. It is recommended that this be negotiated in advance and specified in the Marital Settlement Agreement to avoid problems during the drafting stage.

The marriage coverture formula has also been applied by the State of Wisconsin in Court of Appeals District IV. However, the formula is used to arrive at a percentage of a divisible plan rather than as the formula set forth in a QDRO. In the Marriage of Halverson v. Halverson Case No. 00-1884, the coverture fraction was applied to arrive at the appropriate percentage other than a 50/50 division to

use on a WRS QDRO. In this case, the parties were married for approximately 7.5 years and the husband was a participant in the WRS plan for approximately 20 years. The court used 6.5 years as the numerator. Therefore, 32.5% was considered as a marital component of the plan. The QDRO awarded 16.25% to the former spouse. Another interesting part of this case is that the court used 6.5 years as numerator even though the marriage was 7.5 years in length because the participant did not work for a full year during the marriage due to brain surgery. Although the pension is a marital asset, the court has discretion in its division.

Many plan administrators will provide you with a “model” QDRO specific to their plan. Certainly using the “model” QDRO will make your task much easier and assuming you follow the form, the plan administrator will “qualify” the order much more efficiently and quicker than a draft they have never seen before. We see numerous different models from a variety of sources and there are approximately 15 “model QDRO’s” on the State Bar web site. However, some of these QDRO’s are very good while others are simply not so good. Many others are drafted in a manner that would be unfair to the alternate payee. We have even seen QDRO’s that unfairly reduce the retirement benefits paid to the participant. Consequently a one or two works for all “model form” QDRO simply does not exist in the perfect world. Therefore, a model form QDRO should be looked over carefully to determine the impact on the retirement benefits payable to each party and whether or not the party wants their benefits allocated in the manner suggested by the model QDRO.

Clearly an attorney should not simply fill in the blanks of “model documents”, but rather gain a thorough understanding of the retirement plan and its benefits, leading to his/her own draft to submit to the plan administrators. Discovery, analysis and a pension valuation should be completed before the negotiation and drafting of a QDRO begins.

## **Role of the Expert**

The effect of equitable distribution upon divorce has created a new emphasis toward the economic aspects of marriage. These include valuation, division and tax considerations of marital property. The concept of equitable distribution of property also brought the need for attorneys to find and use experts to establish many of the values. Just about every divorce case involves tax issues and retirement plan issues, some simple, some complex. The attorney and client need the help of the expert in these matters.

The financial expert in particular can provide a myriad of services to the client and attorney. These include developing a theory of the case, valuation of a business, marshaling the assets, providing tax advice, preparing an expert report, testifying at trial, assisting the attorney in cross-examination of the opposing expert as well as helping to negotiate a settlement. No case should be settled without consideration of the tax aspects of the entire settlement. Finally, the expert may also help the attorney in following-up after the divorce is final to facilitate an equitable and orderly bifurcation of the marital assets. These include the transfer of assets from one spousal account to another, assistance with the draft of the QDRO, follow-through with the change of beneficiary designations, re-title of assets, estate planning issues etc.

Be certain to check with your financial advisor to see that they have the proper level of errors and omission (professional liability) insurance. Many advisors such as the author carry specific professional liability insurance for providing advice to attorneys related to the financial aspects of divorce, taxes, financial planning and investments.

## Special Issues

### Death of a Participant

Pension benefits in pay status may cease being paid or they could be forfeited to the plan upon the death of a single plan participant<sup>17</sup> prior to or after the commencement of the benefits. If a plan will recognize an independent interest QDRO, the alternate payee's awarded share of the participant's benefits will not be affected by the participant's death. If the alternate payee is deemed the "surviving spouse" for pre-retirement survivor annuity (QPSA) benefits, said QPSA benefits may commence immediately after the death of the participant, or they might be delayed until the date the participant would otherwise have been eligible to receive retirement benefits. The terms and conditions of the plan apply.

**PRACTICE TIP:** Attempt to determine whether or not pre-retirement survivor benefits are necessary to secure the alternate payee's awarded share for the remainder of the alternate payee's life. If they are not necessary, excessive verbiage may be confusing. If they are necessary, be certain to specify to what extent the alternate payee is covered. Many plans allow only one "survivor" in particular with pre-retirement survivor benefits. Otherwise the alternate payee may experience a windfall upon the death of the participant at the expense of the subsequent spouse. For example, a participant is divorcing and has 20 years of service and accrued a benefit of \$1000 per month. A QDRO awarded the former spouse a 50% interest in the participant's monthly-accrued benefit as of the date of divorce. Assume over the next 10 years the participant's benefit increases to \$2000 per month and the QDRO provided for a 50% pre retirement survivor annuity to his "former spouse". Subsequently, the participant dies prematurely

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<sup>17</sup> See 29 U.S.C. § 1055(a)(2) Provides joint and survivor annuity to spouse regardless if death occurs before or after retirement

and now his former spouse receives \$1000 per month (50% survivor) and his current widow receives nothing.

### **Disability of Participant**

In some plans the disability of a participant can trigger commencement of retirement benefits, regardless of age. If a participant becomes disabled and pension eligible, then the alternate payee becomes eligible to receive pension benefits, even if the disability is prior to the earliest retirement age. Conversely, the disability of a participant could also prohibit an alternate payee from commencing receipt of her benefit until the date on which the participant would have attained the normal retirement age under the plan. For example, if disability triggers a benefit unrelated to the pension, such as an insurance benefit, the terms of the plan may read that the participant will not become eligible to commence his benefit until his age 65. If these are the terms and conditions of the plan, then the alternate payee will not be eligible to commence receipt of her benefit until the participant reaches age 65.

**PRACTICE TIP:** A general clause that requires the alternate payee's benefit be payable at the time and in the manner described, regardless of a participant's disability, should be sufficient for the Plan to notify you if the terms of the Plan are contradictory to the intent of the parties. In general, if the plan provides for disability benefits payable from the plan, special language needs to be inserted regarding the allocation of those disability benefits. If disability is paid from a separate insurance policy for example, a QDRO does not generally need to address disability, other than the consequence with a Shared Interest QDRO and disability could trigger a delay in benefits.

### **Termination of Employment of Participant**

Termination of employment prior to retirement eligibility will generally not cause benefits to become payable under a defined benefit plan. However, the terms and conditions of the plan will apply. Normally the participant and alternate payee must wait until the participant attains the earliest retirement age under the plan before either of them can begin receiving benefits. Some plans require a terminated employee to wait until the normal retirement age before they become pension eligible. Language to the effect that the alternate payee is allowed to select the earliest retirement age of the participant under the plan is sufficient to facilitate a distribution at the participant's termination, provided the plan will recognize the participant as retirement-eligible upon termination.

### **Death of Alternate Payee**

In a defined benefit plan, if the alternate payee dies prior to the commencement of benefits, said benefits will usually revert to the participant or be forfeited to the plan. If the alternate payee dies after commencement of benefits, the form of benefit elected at retirement will determine whether any amounts are payable following death. Often an alternate payee is limited to selecting a single life only option, which means that nothing further will be payable after death. In the event the Plan allows for payment under a period certain option, such as one that provides guaranteed payments for a specified period of months regardless of the survival of the payee, then an alternate payee may elect such option and designate a beneficiary, including a subsequent spouse.

Generally beneficiary designations are not allowed by an alternate payee in a defined benefit plan unless a specific death benefit is payable. Several plans pay lump sum death benefits, a proportionate amount of which can be awarded to an alternate payee in a QDRO. The terms and conditions of the Plan will apply.

Although a plan administrator is not required to accept a QDRO that names the children of the marriage as "contingent alternate payees", some will. I.R.C. §

414(p)(8) states that the order must name each alternate payee. It does not limit a QDRO to name a single alternate payee. The same Code also states that an alternate payee may be a spouse, former spouse, child or other dependent of the participant. If a plan accepts a QDRO with contingent alternate payees, usually it is only for the pre-retirement period that such contingent alternate payees will be recognized. In other words, the children of the marriage may receive the alternate payee's benefits if the alternate payee dies prior to alternate payee commencement of benefits. However, once the primary alternate payee begins to receive benefits, the form of benefit elected will determine whether or not amounts will be payable after death.

If an alternate payee is awarded a portion of a defined contribution plan, often the award is distributable immediately, and there is no concern over how the alternate payee's share will be paid in the event of death. However, some defined contributions require that a separate account be maintained for the alternate payee's award, and alternate payee is restricted from taking a distribution until the participant terminates employment, dies, becomes disabled or is eligible to retire. In such circumstance, the alternate payee should be allowed to name a beneficiary to the proceeds of alternate payee account. The beneficiary may be any person that the alternate payee may choose, including a subsequent spouse. It is also possible to require the alternate payee to maintain the former spouse as the beneficiary, which could be used to secure or guarantee support payments in the event of a premature death for example. Nonetheless, it is often an overlooked bargaining tool.

**PRACTICE TIP:** In a defined benefit plan, don't risk complete forfeiture of the alternate payee's benefits if alternate payee dies prior to commencement of benefits. A QDRO can specify that the alternate payee's benefits shall revert to the participant in the event of alternate payee pre-retirement death. While not all plans will approve this provision, in most cases it is worth an attempt. The

alternate payee gains nothing from this reversion clause except that additional concessions could be secured for the alternate payee in exchange for including it.

If a plan will recognize the children of the marriage as contingent alternate payees, the drafter of the QDRO may wish to confirm how the plan interprets “child of the participant”. Some plans will recognize a child of the participant regardless of their age. Other plans will define such term as a minor child, and once that child reaches the age of majority they are no longer eligible to be considered a contingent alternate payee, regardless of the fact that he or she is still the child of the participant. If allowed, you could effectively get an alternate payee’s awarded share to the alternate payee’s children in the event of premature death before benefits commence. It is possible that the participant may remarry. You need to be certain with the language that you are not giving away the entire survivorship benefit to the alternate payee. Therefore language should be included to limit the alternate payee’s awarded share to the date of divorce if that is desired.

### **Early/Late Retirement Benefits**

Subsidized early retirement benefits are often offered by employers as enticements to retire early. In other words, if an employer wants to reduce the work force, it may offer an increase in retirement benefits to induce more employees to retire early. Sometimes these types of benefits are referred to as supplemental social security benefits or temporary benefits. In some cases, an employer will offer the same benefit payment otherwise payable at age 65 to an employee that is only age 60, without any reduction for early retirement. The difference between the total benefit payable at age 65 and the reduced benefit that would otherwise be payable at age 60 is the subsidized portion of the benefit. In many cases the plan allows for a social security subsidy in that the plan pays a benefit prior to age 62 that is the equivalent of the total benefit plus social security at age 62. In other words, the benefit is reduced by the amount of social security

paid at age 62 to allow for better budgeting and consistent cash flow through the retirement years.

A subsidized benefit is often offered as a result of the number of years of service performed by a participant. It can be argued that the alternate payee is entitled to receive a proportionate amount of any early retirement subsidy paid to the participant. However, an alternate payee generally cannot receive any portion of a subsidized early retirement benefit until the participant is actually receiving subsidized retirement benefits and a QDRO assigns<sup>18</sup> her a proportionate share of the same. If an alternate payee begins to receive benefits prior to the retirement of the participant, and the participant subsequently retires with subsidized early retirement benefits, many plan administrators will recalculate the alternate payee's benefit upon the participant's retirement so that the alternate payee also receives a share of the subsidy that the participant has started to receive, if the QDRO so directs.

Subsidized benefits may not be freely disclosed by the plan, and as such can be difficult to identify. Even if a plan denies payment of subsidized early retirement benefits in the past, it is very possible that it could happen in the future. QDRO's can provide for the division of subsidy, even if it is not payable at the time.

**PRACTICE TIP:** To avoid possible disagreements, negotiations with the parties prior to QDRO preparation should include whether and how to divide potential subsidized early retirement benefits. Subsidized early retirement benefits are often a function of all of the years of service a participant completes. The most equitable means of dividing a subsidy may be to limit the alternate payee's entitlement to an amount that is proportionate to her awarded share of the participant's benefit, as compared to the total unsubsidized retirement benefit.

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<sup>18</sup> See *Alby v. Alby* 155 Wis. 2d 286, 445 N.W.2d 632 (Ct. App. 1990)