Are Your QDRO Practices Costing Your Plan Money?

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benefits
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Complying with qualified domestic relations orders (QDROs) can be complicated. This article covers the basics of QDRO administration and points out the common mistakes plans make.

"Internal Revenue Code Section 414(p): A domestic relations order meets the requirement of this paragraph (i.e., to be a "qualified" domestic relations order, or QDRO) only if such order . . . (B) does not require the plan to provide increased benefits (determined on the basis of actuarial value). . . ."

One sentence. That's all it is. Yet that word *actuarial*, as you might expect if you have ever worked with an actuary, can be mischievous at best and downright diabolical at worst. It means that all domestic relations orders (DROs) must, theoretically, be reviewed by an actuary for compliance. Often, they are not. They are handled by administrative staff or perhaps legal counsel, who may or may not have a checklist of items against which the DRO is measured. Does it specify the plan to which the DRO is addressed? Does it provide the names and addresses of the alternate payee(s)? And so on.

This article will cover some of the problems the authors have had to address over the years when assisting plan sponsors with the administration of QDROs, focusing on the Code section cited above.

Background

Before 1984, plan administrators sometimes were caught between a rock (a federal law known as the Employee Retirement Income Security Act (ERISA)) and a hard place (a court order mandating that a portion of a pension plan participant's benefit be assigned to somebody else, usually in connection with a divorce proceeding). ERISA had banned assignment of pension benefits in what has been called the *antispendthrift provision.*

On August 9, 1984, the U.S. Congress enacted the Retirement Equity Act, which made a major exception to the antiassignment rule. For the first time since ERISA's enactment in 1974, a plan sponsor could comply with a DRO that assigns all or a portion of a participant's pension provided certain conditions are met. If the plan determines that the conditions are indeed met, then the order is said to be *qualified.* Hence, the name *QDRO* (pronounced by most today as "qua-dro").

Separate or Shared

There are two main approaches to dividing benefits in a QDRO: a shared payment approach and a separate interest approach.

1. Under the *shared payment* approach, the alternate payee receives a portion of the actual benefit payments made with respect to a participant. Importantly, the plan pays exactly what it would have paid absent the QDRO. If the alternate payee dies before the participant, the alternate payee's benefits revert to the participant or, perhaps, a contingent alternate payee. If the participant dies first, the plan pays in accordance with the form of payment selected at the annuity starting date. All payments would stop, for example, if payments were being paid on a single life annuity—including the payments being made to the alternate payee.
2. Under the *separate interest* approach, the alternate payee receives a portion of the participant's interest in the plan in a form that is separate from and independent of the benefits payable to the participant.

It is convenient to think of a plan that purchases annuities from an insurance company every time someone retires.

TABLE

How Fiona's Retirement Age Affects Max's Benefit

Fiona's Retirement Age	55	56	57	58	59	60	61	62	63	64	65
Max's Recalculated Monthly Pension	$500	$470	$440	$410	$380	$350	$320	$290	$260	$230	$200

Note: Max's benefits are reduced to reflect the actuarial equivalent of benefits he receives if he begins receiving benefits before Fiona retires.

In a separate interest QDRO, two different annuities would be purchased completely independent of each other, but the cost would equal what the plan would have paid absent the QDRO. In a shared payment QDRO, only one annuity would be purchased.

Here are five areas where a plan sponsor's QDRO practices may be costing them money.

1. Early Retirement Subsidies

In our experience, the most frequent and most costly (to the plan) violations to the Code section referenced above occur when a defined benefit pension plan has subsidized early retirement benefits and an alternate payee begins payments before the participant retires but after the participant becomes eligible for those early retirement subsidies.

An early retirement subsidy occurs when a plan pays a benefit at retirement prior to the plan's normal retirement age that has a greater actuarial present value than the normal retirement benefit. For example, if a plan has a normal retirement benefit of $1,000 per month payable at the age of 65, the actuarial equivalent payable at the age of 55 might be $400 per month. Anything greater than that would be considered a subsidized benefit. If a certain plan allowed unreduced early retirement benefits for a participant, say aged 55 with 30 years of service, that participant would be eligible to receive the full $1,000 per month, $600 of which would be considered a subsidy.

We'll give a quick quiz in a moment, but first let's review three of the rules dealing with subsidized early retirement benefits and QDROs.

1. A plan is permitted to pay an alternate payee before the participant actually retires if the QDRO so states and the participant is eligible to retire.
2. A plan is not required to pass on early retirement subsidies if the participant has not yet retired.
3. If the QDRO so states, the benefit payable to the alternate payee can be recalculated to reflect the early retirement subsidies, if any, once the participant actually retires.

Let's assume the following: Fiona is a participant in Plan A, she has attained the age of 55 and there is a DRO, approved by Plan A as a QDRO, that assigns Fiona's ex-husband, Max, 50% of her benefit accrued through the date of divorce, payable over his lifetime beginning when Fiona is first eligible to retire.

Fiona has 30 years of service covered by Plan A and is eligible to retire immediately with a $1,000 per month pension but does not retire and continues to work. Max, also aged 55, elects to begin his pension right away. Plan A correctly begins paying Max $200 per month (that is one-half of the nonsubsidized early retirement benefit).

The QDRO was drafted by an experienced practitioner and contained a provision requiring Plan A to recalculate Max's benefit in this situation if and when Fiona finally retires and is eligible to receive that early retirement subsidy. Fiona retires at aged 58 with an unreduced early retirement and begins receiving $500 per month with respect to her half of the $1,000 accrued pension that was not assigned by the QDRO (plus any pension earned in excess of $1,000 that was not affected by the QDRO).

What is the recalculated pension payable to Max?

A. $200

B. $500

C. None of the above.

The correct answer is C. Otherwise, there would be no point to this article. Some plans that we have seen would increase Max's pension to $500 because that is what Fiona is now receiving with respect to the pension split 50-50 by the QDRO. But that does not take into account the fact that Max has been receiving $200 per month for three years and Fiona has not. The correct recalculation would increase Max's pension to $500 less the actuarial equivalent of the benefits that Max has already received. We would have provided a table or a spreadsheet to Plan A that would provide the correct recalculated amount

takeaways

- Qualified domestic relations orders (QDROs) assign all or a portion of a participant's pension to another person and must meet certain conditions.
- The two main approaches to dividing benefits in a QDRO are the shared payment approach and separate interest approach.
- The most frequent and costly violations to the Code section governing QDROs occur when a defined benefit pension plan has subsidized early retirement benefits and an alternate payee begins payment before the participant retires but after the participant becomes eligible for the subsidies.
- The shared payment approach is recommended for QDROs that are entered after a participant retires.
- Other situations to look out for include disability pensions and how to treat a QDRO if a participant goes back to work after retiring.
- Plan sponsors can improve QDROs by providing participants with sample DROs, which will ensure that the DRO contains all legally required information as well as details on how the order should be implemented.

that would depend on the date Fiona actually retired. The table would look something like the table on page 39:

Note the logic here. Even if you are not an actuary, the age 65 number should make sense. There is no longer any early retirement subsidy payable. Fiona did not retire early. Max has been receiving the $200 per month for ten years and will continue to receive that amount for the rest of his life. Fiona is receiving a larger amount but did not begin receiving it until the age of 65. If there had been no QDRO, she would have received $1,000 per month starting at the age of 65. If Max had not started his share of the pension early but instead waited until Fiona retired, he would have received $500 per month, Fiona would receive $500 per month and the plan would be in the same position as if there had not been a QDRO .

Looking at the other extreme, if Fiona had retired at 55, Max's and Fiona's pensions would have been $500 each. If there had been no QDRO, Fiona would have received $1,000 per month. From an actuarial perspective, it would make no difference whether two 55-year-olds are paid pensions of $500 per month each or one 55-year-old is paid a pension of $1,000 per month.

2. Postretirement QDROs

If a QDRO is entered after a participant retires, a shared payment approach should be used. In essence, the plan sends a portion of the participant's benefit in pay to the alternate payee. An actuarial calculation is not required, and the alternate payee is restricted from receiving any survivor benefits that were not in place at the original retirement date. Pension Benefit Guaranty Corporation (PBGC) regulations specifically authorize postretirement QDROs but allow plans to restrict them to the shared payment variety.

3. Disability Pensions

Disability pensions create special problems. Many plans treat pensions payable to someone who has become disabled as a temporary benefit payable until the plan's normal retirement age or, if earlier, recovery from the disability. If the person remains disabled until the normal retirement age, the disability pension is then converted to a normal retirement benefit. For these plans, it makes sense to restrict QDROs to the shared payment type during the period prior to normal retirement and then allow the normal retirement benefit to be either shared payment or separate interest.

If a plan treats a disability pension as a lifetime pension and the QDRO uses the separate interest approach, care should be taken so that the disability mortality is used to value the pension that is being assigned. Otherwise, the plan would be converting a pension payable over a disabled life (less costly) to one payable over a healthy life (more costly).

4. Suspension of Pension Payments for Postretirement Employment

QDROs usually are silent as to what happens to an alternate payee's pension if the participant's benefit has been suspended because of reemployment after retirement. We would argue that the alternate payee's benefits should be suspended as well. Otherwise, the plan is paying out more than it would have absent the QDRO, a violation of the Code section quoted at the beginning of this article.

Compare this situation with our early retirement example above. Imagine Fiona had retired at 55 and, in accordance with the terms of the QDRO, both Fiona and Max began to receive $500 per month. Then, six months later, Fiona returned to work and her pension was suspended. Either Max's pension should also be suspended or it should be reduced to remove the early retirement subsidies.

5. Acceptance of Poorly Drafted DROs as QDROS

Sometimes we are asked to calculate the amounts payable to an alternate payee or the participant whose benefits have been partially assigned by a QDRO that we find to be unclear, inconsistent or incomplete (or all of the above).

We find that the QDRO was approved many years earlier and there is little, if any, documentation of the original intent of the parties involved. Administrative staff is faced with the choice of asking participants to revise the QDRO, which would involve additional legal costs for the participant and/or alternate payee, or implementing the QDRO using a "best guess" approach that may or may not align with the original intent.

A plan may mitigate this issue by providing its participants with sample DROs. By establishing a template, the plan controls the format of the document and can ensure that the DRO contains all legally required information as well as details on how the order should be implemented. Some implementation issues that could be addressed are:

- What happens if the alternate payee dies prior to commencement?
- What happens if the participant dies prior to commencement?
- Are benefits payable to the alternate payee recalculated if the alternate payee retires before the participant and the participant retires with an early retirement subsidy?
- What happens if the participant becomes disabled?
- What happens if the participant returns to work?

For additional information regarding QDROs and to view samples, we recommend reading "Qualified Domestic Relations Orders & PBGC," which can be found at www.pbgc.gov/documents/qdro.pdf.

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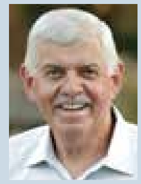

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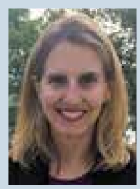

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