Domestic Relations Orders and Non-Qualified DC Plans

Some considerations in handling DROs with NQDC Plans.

By Lee Nunn

Divorcing couples need to consider retirement benefits in any division of marital property. When a soon-to-be former spouse is an executive, benefits that may be payable under a nonqualified deferred compensation plan may be a desirable source for retirement benefits. Dividing these nonqualified benefits can be more difficult than dividing qualified plans, such as 401(k) plans and pensions. The difficulty can be so great that assigning other assets to the non-employee spouse is easier, and the nonqualified benefits are only factored into the total amount of marital assets. In other cases, the portion of marital assets represented by nonqualified benefits is so great that assigning nonqualified benefits to the non-employee spouse is unavoidable.

The more familiar qualified domestic relations order (QDRO) rules under ERISA and the Internal Revenue Code do not apply to nonqualified deferred compensation structured as a top-hat plan, which is an unfunded arrangement limited to a select group of management or highly compensated employees. In fact, some top-hat plans restrict payments during the employee's lifetime to the employee under an anti-alienation provision. Top-hat plans are not subject to the QDRO rules of ERISA but are subject to the pre-emption rules of ERISA. Because ERISA rules that preempt state laws do apply to top-hat plans, a divorcing executive and spouse cannot rely on state domestic relations law to force an employer to accelerate benefits payable under a nonqualified plan. However, a court might succeed in forcing an employer to pay scheduled benefits to a former spouse rather than the employee, much in the same way that a court could force garnishment of pay for alimony or debt payments.

Current tax law permits employers to accelerate the payments of nonqualified benefits under a domestic relations order (DRO), but acceleration is not obligatory under the tax rules. A DRO differs from a QDRO in that a DRO does not meet various criteria that put the "Q" in QDRO. Employers that do allow acceleration of benefits would necessarily limit the amounts to benefits to which the participating employee has a legally binding right and are not subject to a substantial risk of forfeiture, and may require that a DRO include specifics similar to that of a QDRO.

Employers

ERISA and the tax doctrines of assignment of income and economic benefit may allow employers to refuse to accelerate benefits to comply with a DRO, but employers may be less successful in refusing to pay benefits as scheduled under the plan to the non-employee spouse under a DRO. However, the IRS has said that a nonqualified deferred compensation plan may provide for an acceleration of the payment of benefits pursuant to a DRO. The IRS evidently views the acceleration of the payment of benefits pursuant to a DRO in the same way as an acceleration of payment in the event of death, disability or an unforeseeable emergency, except those distribution events are in the statute.

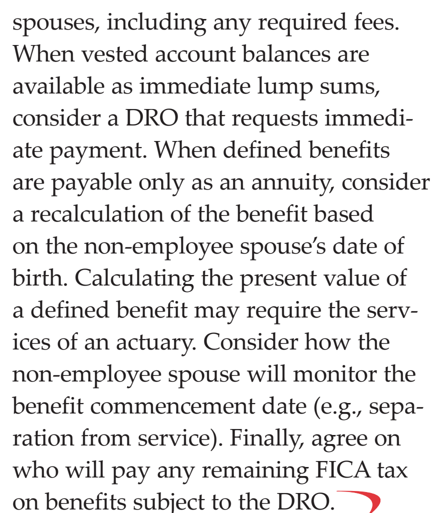
Rather than fighting all payments to non-employee spouses during the employee's lifetime, employers should consider a simple and consistent policy of handling payment requests under a DRO. For vested account balances (e.g., elective deferral accounts), employers should consider immediate payout of the lesser of the vested account balance or the amount specified in the DRO to avoid keeping track of which balances belong to the employee and which balances belong to the non-employee spouse. For vested defined benefit arrangements paid as an annuity, employers should consider recalculation of the actuarially equivalent DRO benefit based on the non-employee spouse's date of birth. This avoids a life payout on the employee's life where payments stop before or after the non-employee spouse's death. Some employers charge employees for the reasonable costs associated with calculating and making payments under a DRO. However, it is possible that the anti-alienation language in a plan and the tax doctrines may make it difficult for a judge to enforce a DRO against the plan.

Tax Reporting and Withholding

Report payments to a non-employee spouse on IRS Form 1099-MISC and withhold federal income taxes based on supplemental rates, which are 25 percent on the first $1 million of supplemental wages payable to the non-employee spouse and 39.6 percent on the excess. A DRO does not change the amount or reporting of FICA taxes, which are reported on the employee's IRS Form W-2, but the DRO should specify whether the employee's wages or the non-employee spouse's benefits are the withholding source for those FICA taxes. State taxes may depend on where the employee earned the benefit (rather than the non-employee spouse's residence state) when federal law does not protect the benefit from taxation by the state(s) in which the benefit was earned. Close coordination with the payroll department is crucial to proper tax reporting and withholding.

Executives

Executives who are negotiating divorce settlements should consult a family law attorney with expertise in retirement plans. The attorney should arrange to inventory all retirement benefits, including nonqualified deferred compensation. The inventory should include all plan documents and an understanding of the amount, vesting provisions, and timing of all benefits. Executives should confirm corporate policies on acceleration of nonqualified benefits and payments to non-employee spouses, including any required fees. When vested account balances are available as immediate lump sums, consider a DRO that requests immediate payment. When defined benefits are payable only as an annuity, consider a recalculation of the benefit based on the non-employee spouse's date of birth. Calculating the present value of a defined benefit may require the services of an actuary. Consider how the non-employee spouse will monitor the benefit commencement date (e.g., separation from service). Finally, agree on who will pay any remaining FICA tax on benefits subject to the DRO.



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