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It's a Simple 401(k) QDRO, What Could Go Wrong?

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Although a qualified defined contribution plan QDRO is generally less complicated than a defined benefit plan QDRO, there are still areas which should not be overlooked if you are preparing your own QDRO or outsourcing to your preferred QDRO provider. The purpose of this article is to explain why an account tracing may still be "best practice" even if the 401(k) plan is entirely community property on the date of separation.

Example: Assume participant and alternate payee separated in 2012 and are now just getting around to dividing the account by QDRO. (Yes, this should have been done years ago but we all know that is rarely the case). The company outsources their QDRO administration to a third party administrator (TPA) such as Fidelity, Vanguard or Schwab, and the QDRO procedures say the order may use an award date in 2012. On the surface this would seem like an easy enough QDRO with alternate payee receiving 50% of the account balance on the date of separation, adjusted by investment experience from 2012 through the date the funds are distributed to alternate payee. However, it is worth looking more deeply at how the TPA actually calculates the gains/losses on alternate payee's award.

Account balance on Date of Separation is $600,000, split equally between parties

Total employee/employer contributions of $20,000/yr:

		TPA Calculation				
Date	Description	Participant	P (%)	Alternate Payee	AP (%)	Total
12/31/2012	Balance	$300,000	50.00%	$300,000	50.00%	$600,000
	All contributions '12-'19	$140,000				$140,000
12/31/2012	Adj Balance	$440,000	59.46%	$300,000	40.54%	$740,000
	Gains/losses	$571,980		$389,986		$961,966
12/31/2019	Balance	$1,011,980	59.46%	$689,986	40.54%	$1,701,966
		Participant		Alternate Payee		
		$1,011,980		$689,986		

Fig.-1

As you can see from the illustration above (Fig-1), the TPA adds up all contributions between 2013 and 2019 and allocates the total $140,000 in contributions to participant's date of separation balance. This immediately reduces the alternate payee's awarded interest from 50% on the date of separation to 40.54%, with a final payout of $689,986. **This is an error in the TPA's methodology for allocating investment return.**

"Best Practice" would be to have a more detailed calculation prepared based on the periodic statements from 1/1/2013 through 12/31/2019 as follows:

		Correct Calculation				
Date	Description	Participant	P (%)	Alternate Payee	AP (%)	Total
12/31/2012	Balance	$300,000	50.00%	$300,000	50.00%	$600,000
	EE/ER Contributions	$20,000				$20,000
	Gains/losses	$94,525		$91,475		$186,000
12/31/2013	Balance	$414,525	51.43%	$391,475	48.57%	$806,000
	EE/ER Contributions	$20,000				$20,000
	Gains/losses	$54,512		$50,268		$104,780
12/31/2014	Balance	$489,036	52.54%	$441,744	47.46%	$930,780
	EE/ER Contributions	$20,000				$20,000
	Gains/losses	$3,160		$2,797		$5,957
12/31/2015	Balance	$512,196	53.54%	$444,541	46.46%	$956,737
	EE/ER Contributions	$20,000				$20,000
	Gains/losses	$57,416		$48,878		$106,293
12/31/2016	Balance	$589,612	54.44%	$493,418	45.56%	$1,083,030
	EE/ER Contributions	$20,000				$20,000
	Gains/losses	$124,767		$102,670		$227,436
12/31/2017	Balance	$734,379	55.20%	$596,088	44.80%	$1,330,467
	EE/ER Contributions	$20,000				$20,000
	Gains/losses	($36,941)		($29,582)		($66,523)
12/31/2018	Balance	$717,438	55.88%	$566,506	44.12%	$1,283,944
	EE/ER Contributions	$20,000				$20,000
	Gains/losses	$223,763		$174,260		$398,022
12/31/2019	Balance	$961,200	56.48%	$740,766	43.52%	$1,701,966
		Participant		Alternate Payee		
		$961,200		$740,766		

Fig.-2

Allocating participant's separate property contributions over time as they were actually contributed, instead of all $140,000 on 1/1/2013, along with more frequent reconciliation of investment return, yields alternate payee a final payout of $740,766 (which is $50,780 *MORE* than alternate would have received had there been no tracing).

It should be understood that alternate payee is not "reaching over the fence" into participant's portion of the account as a result of this calculation, merely alternate payee is receiving one-half of the community interest correctly calculated.

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The methodology used by many TPAs can also unintentionally benefit the alternate payee instead of the participant, typically in periods of negative investment returns. Had the account lost value during the 2013-2019 period, participant would have received a disproportionate share of such losses to the benefit of alternate payee.

Practice Tip: When there have been post-separation separate property contributions by participant, consider having the community and separate property interest calculated through a current date prior to entering the QDRO.

We recommend discussing the need for an account tracing with your preferred QDRO provider.

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