

THE ASPPA Journal

ASPPA's Quarterly Journal for Actuaries, Consultants, Administrators and Other Retirement Plan Professionals

The Fly in the Ointment: Plan Loans and QDROs

by Michael P. Coyne and Jane E. Kleinsmith

John Doe is a participant in his company's profit sharing plan. He has an account balance of \$40,000, which includes a participant loan with an \$18,000 outstanding principal balance. Recently, the plan administrator received a proposed qualified domestic relations order (QDRO) providing that 60% of Mr. Doe's account is to be segregated for the benefit of ex-Mrs. Doe as part of a divorce settlement and paid to her as soon as permitted by the terms of the plan. Like many QDROs, the order is silent as to how the specific assets are to be segregated and whether the loan should be included or excluded in calculating the account balance.

Consider all of the problems facing the plan administrator. First, 60% of Mr. Doe's account is \$24,000, and that amount exceeds the amount of liquid investments in his account. Additionally, if the plan administrator is to provide the alternate payee with 60% of each investment, it would seem that \$10,800 of the plan loan should be allocated to her. But there are more problems. The order calls for a distribution as soon as permitted under the terms of the plan, and the terms of the plan permit a distribution at any time to the alternate payee. How does the plan administrator comply with this part of the order? Even if all of the liquid investments are allocated to the alternate payee, a complete distribution is not possible. Should part of the loan be distributed? Is that even possible? Should the trustee be asked to borrow funds to make the distribution?

If the distribution to the alternate payee does not take place immediately, it would be possible to divide the participant loan between the participant and the alternate payee. In the John Doe example, as payments were made on the loan, 60% would be allocated to the alternate payee's account and 40% would be allocated to the participant's account. However, this approach may create significant



administrative problems. We have been advised that some plan administration software is not designed to split loan payments between separate accounts.

Additionally, if the loan is split, then the plan needs to be worried about whether the loan is adequately secured. Following division of the accounts, the participant's account balance is only \$16,000. The outstanding loan balance exceeds that amount. Does the alternate payee's account continue to act as collateral for the loan? If so, has a prohibited transaction occurred? Should the plan require additional collateral from the participant?

Default presents some unusual questions as well. If the participant defaults, the defaulted loan is to be treated as a taxable distribution. Does this scenario mean that the alternate payee receives a taxable distribution of 60%

Plan sponsors can avoid many of the obstacles associated with loans and domestic relations orders by carefully drafting loan procedures to ensure coverage of the most common issues.

of the loan? This type of problem will likely lead to a return to domestic relations court, and one would expect the plan to be dragged into litigation by either or both of the parties.

Is it possible to distribute the loan to the alternate payee? While it is legally possible to assign the note to the alternate payee, that approach is not likely a very attractive option for the alternate payee. Unless the note is placed in an IRA, the alternate payee will have taxable income. (Finding an IRA custodian to hold a partial interest in a note may be a challenge.) From the plan's perspective, a transfer of the entire note would be a good resolution, as it would no longer be the plan's responsibility.

In our example, the alternate payee would not be entitled to the entire note, but rather 60% of it. Can the plan assign only an interest in the note? It is possible, but the plan would remain responsible for collecting payments on the note and distributing payments to the alternate payee. Again, this situation is very unattractive to the alternate payee, unless the assignment is transferred to an IRA.

Given the complications associated with participant loans, one would expect divorce attorneys to aggressively negotiate a resolution to protect their clients. Unfortunately, many members of the domestic relations bar do not have sufficient experience with pension law to appreciate the problems associated with plan loans. Tax attorney Stephen H. Leventhal wrote, "The real issue for divorce attorneys is making certain that the language they include in a divorce decree and a QDRO protects their client. For all practical purposes, [pension law] means very little to the attorney who is attempting to negotiate a favorable division of a retirement asset for his client."¹

The rather significant item of court decisions dealing with participant loans and QDROs provides ample evidence of the difficulty of resolving these issues in domestic relations courts. In one case, where the participant loan was not adequately addressed in a QDRO, the court required an alternate payee to repay one-half of the participant loan.² In another case, a domestic relations court's failure to explicitly address responsibility for payment of a participant loan in connection with a divorce action was deemed to be a reversible error.³

Obviously, the nature of a participant loan as a plan asset presents unique issues when retirement assets are being divided in connection with a divorce or dissolution. Fortunately, plan sponsors

who anticipate these problems can resolve most, if not all of them, with carefully crafted loan procedures and standards for reviewing QDROs. The prohibited transaction exemption and regulations that permit participant loans grant plan sponsors fairly wide latitude in developing the rules and conditions under which participant loans will be granted. The only restrictions on such rules and conditions are that they not discriminate in favor of highly compensated employees, officers or shareholders and that they apply to all participants and beneficiaries on a reasonably equivalent basis.⁴

Similarly, plan sponsors are required to adopt reasonable procedures to review QDROs.⁵ Procedures need not be limited to simply determining the qualified status of the order. The statute specifically authorizes procedures "to administer distributions under such qualified orders." Additionally, a plan administrator has the right to insist upon clarity and precision in the qualified domestic relations order and can reject any order that is vague.⁶ Consequently, it is clearly permissible to include in the procedures requirements that the qualified domestic relations order include provisions addressing any unusual situations or potential problems, such as participant loans.

The plan sponsor's objective should be to have procedures that are sufficiently clear and precise so that a participant or alternate payee will have no need or desire to draw the plan into litigation. Plan sponsors should start by considering loan procedures that will avoid many of the problems described earlier in this article. Here are some examples:

- **Prohibit participant loans to any participant who is a party in a divorce action without the consent of the domestic relations court.** It is not unusual for a court to order a freeze on any distributions or participant loans.⁷ Rather than wait for the court to issue an order, simply make this practice a part of the plan's standard loan procedure.
- **Require the participant to acknowledge, as part of the loan application, that he or she is not presently a party to a divorce action.** While it is possible that a participant will falsify the loan application, this acknowledgement will protect the plan from any claim of breach of fiduciary duty. Keep in mind, however, that if the plan administrator has independent knowledge that a divorce is pending, this information is sufficient to allow the administrator to deny the loan, even if the participant answers a question to the contrary.

1 Benefit Practice Portfolios, Drafting the Division of Retirement Plan Assets into a Divorce Decree—Qualified Domestic Relations Orders—(October 2004), by Steven H. Leventhal, J.D., LL.M., Taxation; CCH Benefits Practice Portfolios.

2 *Ouziel v. Ouziel*, 285 A.D.2d 536, 728 N.Y.S.2d 75, N.Y.A.D. 2 Dept., 2001. July 16, 2001.

3 *Shepard v. Shepard*, 2001 WL 57181 (Ohio App. 9 Dist.).

4 §2550.408b-1.

5 ERISA Sec. 206(d)(3)(G)(ii).

6 *Patricia J. Matassarini v. F.F. Mike Lynch, et al.*, 23 EBC 1663, U.S. Court of Appeals, Fifth Circuit, (Apr. 27, 1999).


7 See, for example, *Casey v. Casey*, 2004 WL 3130246, Conn. Super., 2004.

8 IRC Sec. 417(a)(4).

- **Require the spouse's consent to all participant loans, regardless of whether such consent is required by law.** Spousal consent is only required if the participant's account is subject to the joint and survivor annuity rules of Section 401(a)(11).⁸ However, a loan program may nevertheless make spousal consent a requirement for all loans.
- **Provide that any request for a distribution results in acceleration of the loan repayment date.** It would not be permissible to delay a requested distribution due to an outstanding loan. Accelerating the loan payment will eliminate distribution problems.

In addition to these changes to the loan program, a plan's qualified domestic relations procedures should include specific provisions addressing participant loan issues:

- **Require that every QDRO provide specific directions regarding the disposition of any participant loan.** Arkansas benefits attorney, Craig Westbrook, includes the following provision in his procedures for reviewing qualified domestic relations orders: "The plan permits loans to participants. If there is an outstanding participant loan, the order should address the participant loan so that the plan administrator can determine whether the division of the participant's account includes or does not include the participant loan."
- **Provide that the plan will not make a distribution to an alternate payee to the extent that loan repayments are needed to fund that distribution.** This provision might be included in either the loan program or the procedures for reviewing qualified domestic relations orders. Preferably it is included in the QDRO procedures, as it puts the domestic relations attorney on notice of the types of problems that arise with respect to plan loans.
- **Provide that participant loans cannot be divided; they must be allocated to the participant.** Florida benefits attorney, Carol Myers, notes that prohibiting the division of a plan loan will eliminate many of the most difficult legal and administrative issues associated with plan loans.⁹ It may be necessary to amend the plan's loan provisions to allow the plan to request additional collateral if the division of the account pursuant to a QDRO leaves the plan with less than adequate security.

Plan sponsors can avoid many of the obstacles associated with loans and domestic relations orders by carefully drafting loan procedures to ensure coverage of the most common issues. Additionally, a standardized process by which QDROs are reviewed and approved should be implemented. In the absence of proper safeguards, a plan sponsor risks being drawn into domestic relations litigation, which will likely result in increased costs associated with reviewing QDROs. Awareness of potential plan loan issues and standardized procedures for dealing with loans will likely result in the effective, thorough and litigation-free administration of qualified domestic relations orders. 



Michael P. Coyne, JD, is a founding partner of Waldheger Coyne, a legal professional association in Cleveland, OH. He is a fellow in the American College of Employee Benefits Counsel and is a past member of the Internal Revenue Service's Advisory Committee on Tax-Exempt and Government Entities (the "ACT"). Michael is a contributing editor to the Section 401(k) Advisor and is a frequent lecturer on employee benefits matters. (mikec@healthlaw.com)



Jane E. Kleinsmith, JD, is an associate at Waldheger Coyne, with a practice focusing on employee benefits and general tax matters. (jane@healthlaw.com)



⁹ The authors wish to acknowledge the insights and advice provided by Ms. Myers for this article.