MICHIGAN
FAMILY LAW JOURNAL

A PUBLICATION OF THE STATE BAR OF MICHIGAN FAMILY LAW SECTION • HON. RICHARD B. HALLORAN, CHAIR

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VOLUME 46 NUMBER 9 NOVEMBER 2016

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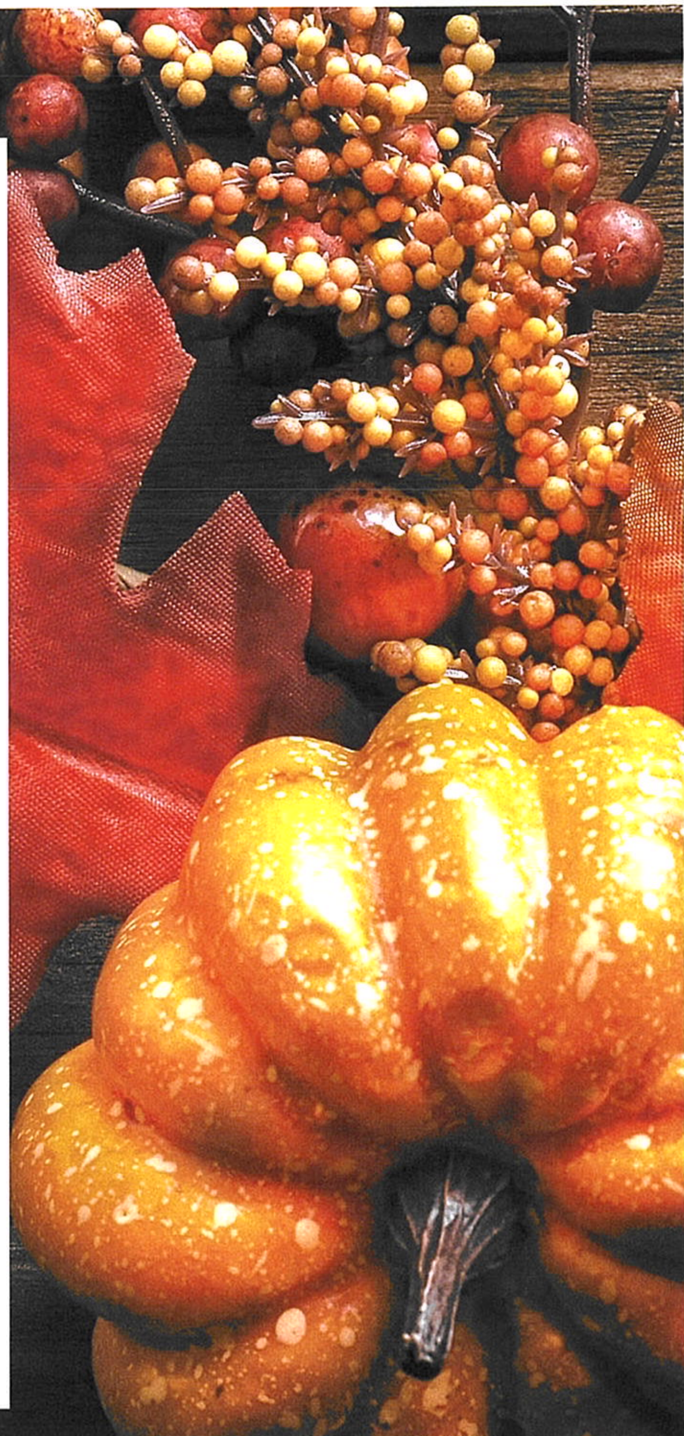

The "Simple" Division Of Defined Contribution Retirement Plans

(Part One of a Two-Part Series)

By Meletios Golematis

Introduction

When compared to the relative complexity of drafting judgment language to divide a defined benefit plan (traditional monthly pension) family law attorneys crafting language to divide a defined contribution plan such as IRC §401(k), 403(b) and 457 plans may not always appreciate the potential pitfalls. This article will highlight some of the most common issues that arise when dividing a defined contribution plan. For illustrative purposes, we will assume the example of the apparently straightforward judgment whose operative language dividing a 401(k) consists solely of: *Alternate Payee is awarded 50% of the value of Participant's 401(k) as of the date of divorce.*

Gains and Losses

Ideally a Qualified Domestic Relations Order (QDRO) dividing the Participant's 401(k) is entered on or shortly after the date the judgment is entered, after which it is sent to the plan administrator to be formally qualified as a QDRO and implemented according to its terms. This process generally takes 30-90 days which results in a time differential between the date of divorce (usually the valuation date) and the date the plan administrator transfers the awarded funds from the Participant's account to the Alternate Payee (segregation date). During this interim period, the funds remain in the Participant's name and account and are subject to earnings (gains and losses) based on the Participant's investment holdings within the account. The question, then, is whether the Alternate Payee's assigned share should likewise be subject to adjustment for gains and losses from the valuation date to the segregation date.

The most common justification for the position that the Alternate Payee's share should be adjusted by gains and losses is that it is fair and equitable for each party to bear the gain or loss as to their respective shares of the plan. If not adjusted by gains and losses, the Alternate Payee will receive a flat sum equal to half the plan value on the valuation date, regardless of investment performance from such date until segregation. Under this scenario, if the plan loses investment value before the segregation date the Participant alone will bear the loss and must cover the difference from the Participant's share of the plan. Conversely, if the plan appreciates in value during this time, the Participant alone will reap the gain. Failure to address this issue in the judgment may lead to further litigation, especially when the difference in value of the award adjusted by gains and losses versus a flat sum is large due to a volatile market or to the all-too-often case of a QDRO entered long after the divorce judgment. The QDRO must likewise address gains and losses or it will be rejected by the plan administrator unless the plan has a default presumption when the QDRO is silent (some plans apply gains and losses in this situation while others will not). In this writer's opinion is a worse outcome since the result is left subject to the random whim of plan policy.

While evident that a well-drafted judgment must address whether the Alternate Payee's award is to be adjusted by gains and losses, there is no definitive Michigan statute or case law governing this issue. MCL 552.101(5) is occasionally cited to support the assertion that when the judgment is silent the Alternate Payee is entitled to a proportionate share of gains and losses. This statute, however, does not contemplate the division of defined contribution plans. Except where expressly excluded in the judgment the statute awards "a proportionate share of all *components* of the pension, annuity, or retirement benefits." The examples of components found in the statute are applicable only to defined benefit plans. More to the point, earnings on a defined contribution plan are not a *component* of the plan but rather the result of fluctuations in the market value of the account investments.

Loans

Most defined contribution plans allow the Participant to take a loan against the plan. Treatment of outstanding loans on the valuation date will affect the calculation of the amount being divided and should, therefore, be addressed in the judgment. Loan balances are deemed an asset of the plan by the plan administrator, who treats it as an account receivable, and may be included in, or excluded from, the portion of the account being divided. In our example, let's assume that just prior to the date of divorce, the Participant had $100,000 in his or her 401(k) but then borrowed $20,000. If the loan balance is *included* in determining the amount being divided

the Alternate Payee will receive $50,000 (50% x $100,000) which means the Alternate Payee's awarded share will be unaffected by the existence of the loan. If the loan balance is instead *excluded* the Alternate Payee will receive $40,000 (50% x $80,000) which has the effect of reducing the Alternate Payee's share by half the loan balance.

As with gains and losses, there is no definitive Michigan statute or case law governing the treatment of loans when dividing a defined contribution plan. As such, the parties should discuss and incorporate into their judgment their intent. Generally speaking, if the loan was taken for the sole benefit of the Participant it is usually included when dividing the plan while the loan is typically excluded if it was used for the benefit of both parties. The liability for a loan from a defined contribution plan is unassignable. Therefore, the Participant will remain obligated to repay the loan regardless of the inclusion or exclusion for purposes of calculating the award to the Alternate Payee. For this reason, the only way for the parties to share the loan burden is to exclude the loan, thereby reducing the Alternate Payee's share by half the loan balance while allowing the Participant to retain an equal amount in the Participant's account.

Vesting

Many defined contribution plans require the Participant to remain employed by the plan sponsor for a specified period in accordance with the plan's vesting schedule before acquiring full ownership of the benefit. The Participant is always 100% vested in his or her own contributions (usually elective salary deferrals) whereas employer contributions like profit sharing and matching contributions are often subject to vesting requirements. While some plans offer immediate vesting of employer contributions most have some sort of vesting schedule.

Family law attorneys should pay careful attention to whether the Participant is fully vested in the plan on the date of divorce or other valuation date. Though a Participant who is not fully vested on the valuation date may have *accrued* both the vested and unvested portions during the marriage, the plan will not honor a QDRO which attempts to award an amount in excess of what is vested on the specified valuation date. This may come as a surprise to an Alternate Payee who has reviewed a recent plan statement and is expecting a larger award than what is ultimately received. Using our judgment example, let's assume that on the date of divorce the Participant's total plan value was $10,000 but that only $4,000 was vested. A QDRO drafted to award, or interpreted by the plan as awarding, 50% of the total plan value of $10,000 will likely be rejected as this would require the assignment of $5,000, which exceeds the vested balance on the date of divorce. If, instead, the QDRO is not rejected because the particular plan has a default presumption that the award be applied only to the vested balance, the Alternate Payee will be assigned $2,000. Each of these outcomes is undesirable if the intended result was to assign half of the total account balance, both vested and unvested (i.e., $5,000).

If the intent is for the Alternate Payee to also receive half the unvested balance—*if and when*—the Participant vests, then the divorce judgment should so provide. Even when this intent is clear, it is often difficult to effectuate as an increasing number of plan administrators require a single valuation date and, will therefore, reject a QDRO which assigns a portion of the award now and the potential remainder in the future *if* the Participant vests. In such cases a creative solution may be required such as drafting two QDROs; one now to award a portion of the vested balance and one in the future to award a portion of what is currently unvested.

For the above reasons, family law attorneys should always consider potential issues related to gains and losses, loans and vesting when negotiating the division of a defined contribution plan. To avoid post-judgment litigation over what was intended the judgment should clearly address these subjects when applicable. The separate matter of drafting a QDRO which both comports with the parties' stated intent and complies with the plan's QDRO policies and procedures is fraught with its own potential pitfalls and should be handled only by someone with extensive experience. The second (and final) part of this article will examine issues which often arise when defining and calculating the marital portion of a defined contribution plan as well as the "equalization" of multiple plans.

About the Author

Meletios "Mike" Golematis *is the senior staff attorney and QDRO consultant at QDRO Express. Mr. Golematis is a 1988 graduate of the University of Michigan where he earned a B.A. in Economics. He earned his Juris Doctor from the Detroit College of Law in 1992. After nearly 20 years in private practice, Mr. Golematis joined QDRO Express where he has drafted, or consulted in the drafting of, well over 5,000 QDROs, EDROs and similar orders dividing retirement plans and participates in the Family Law Section's QDRO and Court Rules Committees. He has also served as the Magistrate for the 28th District Court of Michigan for the last 22 years.*