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The Great Retirement-Swap Imbalance
Cutting Some Divorce Costs Can Cost You Dearly

Divorcing couples are often looking to reduce fees and costs wherever they can. When it comes to dividing retirement plans, certain cost-cutting efforts can be more expensive that you thought.

Many retirement plans require a domestic relations order (DRO) or a qualified domestic relations order (QDRO) to divide the benefits. Cost-conscious couples will often try to combine those retirement plans to limit the number of (Q)DROs needed or eliminate them completely by swapping the estimated value of the plan with another asset (house or other investment) of a similar value. While this may make sense on the surface, the real-life impact deserves a closer look before you make this decision.

Combining and Equalizing accounts
One way to reduce the number of (Q)DROs you need, and, therefore, the related (Q)DRO fees, is to combine and equalize accounts. In doing so, you are assuming that $1 in investments in one account is equal to $1 in investments in the other account. This is rarely, if ever, the case. Depending on the nature of the investments, one party will likely be “shorted” on the investment gains and the other party will receive a “windfall”.

Consider the example of Toni and Pat:

On the date of separation, Pat and Toni have a total of four retirement plans that would each require a (Q)DRO to divide. The accounts in Pat’s name total $1M. The accounts in Toni’s name total $500,000. On average, (Q)DROs run about $1,000 per plan (plus or minus depending on the type of plan), so Toni suggests they (Q)DRO one of Pat’s plans to equalize the difference ($500,000/2 = $250,000), so that each would end up “equal” with $750,000 in retirement funds and they save about $4,000 ($2,000 each) in (Q)DRO fees. (Q)DROs often take several months to more than a year to complete. In Toni and Pat’s case, a year has passed when the actual (Q)DRO division is completed, and Pat’s accounts performed at an averaged 20% market rate, leaving a current value at the time of division of $1,200,000, and Toni’s accounts performed at an averaged 10% market rate leaving a current value at the time of division of $550,000. Neither of them contributed or withdrew funds during that time.

Based on their agreement, Toni now has $800,000 ($550,000 + $250,000) and Pat now has $950,000 ($1.2M - $250,000). They did not end up with $750,000 each, which was the basis of their agreement. Had they “(Q)DROed” all plans, they would have each ended up with $875,000.

End result: Toni saved $2,000 on 1/2 the QDRO fees and lost $75,000 in market appreciation. Pat saved $2,000 on QDRO fees and received a windfall of $75,000.

Swapping Retirement with Other Assets
The first thing to remember here is that the value of the plan on the statement is often not the true value of the plan. For some retirement plans, like pensions, there are no funds in an account (like an IRA). The participant in these plans has earned credit towards future income. The amount will be based on the time the participant invested for that particular employer. This is often referred to as a "defined benefit plan." So, although the CalPERS statement may show a balance of $250,000, there is also fine print on the statement that this is NOT the value of the plan. To get an **estimate** of the value, you will need an actuary to value the plan.

Different assets also have different costs associated with them. Let's assume Toni and Pat have $500,000 in a joint savings account. Since it is a community asset, under California Family Law, each would receive $250,000. Pat suggests Toni just keep the entire amount so that they don't have to (Q)DRO the retirement accounts. Even though the joint account interest rate is much lower, Toni likes the idea of having cash more readily available. Unfortunately, neither has considered the tax consequences. As it relates to the savings account, there are no tax consequences to withdrawing the money. But with the retirement plans, Pat would be hit with ordinary income taxes on the amount withdrawn and, depending on the circumstances, about a 10%+ penalty. So, where Toni gets $250,000 from the account, Pat would actually receive at about $25,000 less, minus ordinary income tax for withdrawing the same funds.

The same is true if Pat and Toni opted to swap Pat's interest in the family home. Again, assuming the net (excluding mortgage) equity value of the home is $500,000, Toni would owe Pat $250,000 to keep all interest in the house. If Pat and Toni decide to not equalize the retirement accounts in exchange for Toni keeping the house, there can be unexpected losses for Toni. A retirement account will continue to grow based on the market… and, yes, there could be significant losses, but history shows that most people see marked gains in the long run. A house requires ongoing maintenance and other out-of-pocket costs such as mortgage, taxes, utilities, and so on. Real property is also subject to market fluctuations. Assuming Pat makes no early withdrawals, there will be no penalties and only income taxes at Pat's then current rate (presumably lower if Pat is no longer working). Toni may end up with an asset that costs more to maintain than Toni can afford later on (when Toni can no longer work). And if Toni's retirement doesn't perform as well as Pat's, Toni could suffer an even greater loss.

It is important to keep in mind that the more varied the investments between the accounts or the types of assets being swapped, the larger the "error factor" will be compared to dividing the accounts separately by (Q)DRO. A (Q)DRO provides an accurate community split of not only the underlying investments as of separation, but also the proportional gains/losses. You can still opt to swap assets or combine accounts if you so choose – just make sure you understand the financial impact before you sign on the dotted line.