Reasons to use a QDRO with married couples

Most people associate a QDRO, a qualified domestic relations order, with a divorce. In fact, it can be a powerful planning tool for happily married spouses.

Created by ERISA, a QDRO allows for the tax-free transfer of qualified plan assets between spouses pursuant to a state's domestic relations code.

It's important to note that a QDRO governs the transfer of qualified plan assets, like a 401(k), from Spouse A to the IRA of Spouse B.

The three-step process includes:

- Interspousal agreement (IA)—a contract between the spouses that arranges for the transfer of qualified plan assets from one spouse to the other spouse's IRA
- Domestic relations order (DRO)—court approval of the IA
- Qualified domestic relations order—review, approval, and execution of the transfer outlined in the DRO by the plan administrator

Note: It is critical that clients work closely with an estate planning or family law attorney to draft the IA and coordinate the legal process.

Here are some reasons a married couple may want to consider a QDRO:

1 Delay required minimum distributions (RMDs)

For married couples with a significant age gap, an older spouse approaching RMD age may not need—or want—to take RMDs and pay the associated tax on the distributions. A 401(k) can be transferred via a QDRO from an older spouse to a younger spouse. In turn, that will delay RMDs until the younger spouse reaches RMD age, when they must begin taking them or face a federal income tax penalty.

Annuity opportunity: The younger spouse can invest in an annuity, which can provide growth potential until they reach RMD age. If they choose to add a guaranteed income for life rider, for an additional fee, it can ensure regular income that they can never outlive. This is important because the younger spouse will likely live longer.

2 Avoid a pre-age 59½ distribution penalty

Withdrawals from a qualified plan prior to age 59½, with limited exceptions, include a 10% tax penalty. Transferring assets via a QDRO from a spouse younger than age 59½ to a spouse older than age 59½ allows access to those funds without the 10% penalty.

Annuity opportunity: If lifetime income is a priority for the older spouse, an annuity with a guaranteed income for life rider, for an additional fee, could be an option. It provides guaranteed annual income without the 10% tax penalty, and generally, the payout percentage will be higher because it is based off of the older spouse's age. Annuity income is taxed at ordinary income tax rates.

3 Other pre-59½ exceptions

First-time home purchase: Couples who are first-time home buyers may need to tap into retirement funds to make a down payment. One option is for a spouse to take a loan from their 401(k), which must be paid back. However, a spousal QDRO can be implemented to transfer the 401(k) assets from one spouse to the other's IRA to utilize the exception to the 10% penalty for pre-59½ withdrawals. This withdrawal does not have to be paid back and is subject to ordinary income tax.

Qualified higher education expenses: Paying for qualified higher education expenses is another exception to the 10% pre-59½ penalty that is unique to IRAs. Again, a spouse can transfer 401(k) assets via a QDRO to the other spouse's IRA and utilize this exception to pay for higher education expenses for themselves or their children. This withdrawal is subject to ordinary income tax.

Review your book of business to see if any of your clients might be in any of these situations. As always, consult with an estate planning attorney on the specific requirements for a spousal QDRO in your state.

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