Properly Address 401(k) Plan Loans in Divorce

By Mary Salisbury On 03/29/2022

Participants in a defined contribution retirement plan (the most common of which is a 401(k) plan) at work often have the ability to take out a loan from their account balance. These loans must be paid back and that is usually done via payroll deduction. When a retirement plan like this is divided in a divorce, it is critical to address any outstanding loans.

When I have a client that has taken out a plan loan and who had an outstanding balance on the Date of Separation, I will treat that loan as reducing the retirement plan account balance to be divided in the divorce while adding a debt that must be divided in divorce. Often, the plan participant has been paying off the loan balance during their period of separation. In these cases, care should be taken to correctly attribute the plan loan repayment and if the plan account is to be divided, to make sure the loan does not get double-counted when setting out the account balance to be divided.

Dividing employee benefit plan accounts in a divorce requires a court order called a Qualified Domestic Relations Order (QDRO) or in the case of government plans, a Domestic Relations Order (DRO). The Plan Administrator will consider an outstanding loan as an asset that should be added to the value of the account to determine the account's true value.

Let’s look at an example: Let’s say a QDRO awards 50% of a participant’s $200,000 account balance to the other spouse (the “alternate payee”) and as of the Date of Separation, there is a $20,000 loan balance. The Plan Administrator values the account balance as $180,000. Let’s also assume that 12 months have gone by since the Date of Separation and the plan participant has since paid back the loan through payroll deductions AND received credit for the $20,000 loan repayment in the property division (i.e. the debt was put on his side of the ledger when the property was divided). If the QDRO does not address the loan, the alternate payee may only be awarded $90,000 ($200,000 less the $20,000 loan balance divided by 2). If that were to happen, the plan participant spouse received credit for the total loan twice-once in the division of property and once in the division of the account balance. In this example, the alternate payee should receive half of the total $200,000 account balance since she already gave the plan participant spouse credit for his $20,000 loan repayment.

As this example shows, it is very important to not only account for the loan balance in the separation agreement but also be certain that the language in the QDRO/DRO also accounts for any loan balance. The QDRO/DRO should be very clear as to how the outstanding loan should be treated (i.e. whether it should be ignored or subtracted from the account balance). Often I see language saying the loan balance should be “included” or “excluded” from the account balance but I’m not certain the plan administrator will understand the intent. Does “excluded” mean the loan is “subtracted from” the account balance or does it mean it should be ignored? The QDRO/DRO should use language making the intent abundantly clear. An “example” written in the QDRO is one way to make it clear to the Plan Administrator how to treat the loan and the division.

Also, if loans are not addressed in a QDRO/DRO, the Plan Administrator may reject the QDRO/DRO for that reason, and then it’s back to the drawing board which can add hefty legal expenses to get the QDRO/DRO corrected.

If a plan participant spouse represents that he or she has not taken out any loans, the separation agreement/settlement agreement should include a statement that the party represents that he or she has not taken any loans or withdrawals from his or her account in the plan. It should also state that he or she is prohibited from taking any loans or withdrawals until a separate interest has been created for the other spouse pursuant to a QDRO/DRO.

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