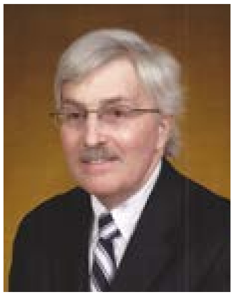

Tax Affecting Plan Loans -

Should the Participant Receive a Credit Against Future Tax for Loans Drawn and Used During Marriage?

By Joseph W. Cunningham, JD, CPA

Consider the following example:

1. Parties - A and B - were married on 7/1/96 and divorced 20 years later on 6/30/16
2. B has been a particpant in her employer's 401(k) plan since before marriage. At marriage, the account balance was $30,000.
3. B had no plan loan balance at time of marriage, but she drew a $50,000 loan from the plan during marriage to provide funds for a family vacation home in northern Michigan.
4. At divorce, the 401(k) account consisted of $100,000 in investments and a remaining loan balance of $20,000.
5. Since the loan funds were used for marital purposes, the unpaid plan loan is a marital debt.
6. Based on these facts, A and B will divide the $70,000 net increase in the account during marriage. A's $35,000 will be paid from non-loan plan assets.
7. B will also receive $35,000 of non-loan assets as well as the $20,000 plan loan receivable for which she is responsible to repay (essentially, to herself).
8. The following presents the division of the account value, including the plan loan receivable.

Overall Summary	Value of Investments	Loan Balance	Total Account Balance
June 30, 2016	100,000	20,000	120,000
July 1, 1996	30,000	0	30,000
Increase	70,000	20,000	90,00

Activity During Marriage "Partnership"	A	B	Total
Investment Value Increase	35,000	35,000	70,000
New Loans	25,000	25,000	50,000
Loan Repayments	(15,000)	(15,000)	(30,000)
Sub-Total	45,000	45,000	90,000
Net Loan to be Paid	(10,000)	(10,000)	(20,000)
Net Value to Divide	35,000	35,000	70,000

Division of the $70,000 Net Value	A	B	Total
Investment Value Increase	35,000	35,000	70,000
Plan Loan Receivable		20,000	20,000
Loan Repayment Obligation		(20,000)	(20,000)
	35,000	35,000	70,000

Comments

1. As the above indicates, the $70,000 increase in the account occured during marriage.
2. B will be responsible to pay the $20,000 loan balance. But, she is essentiality paying this to herself, with the caveat noted below.
3. **Caveat:** She'll be using after-tax dollars to repay pre-tax dollars in her 401(k) account. The $20,000 loan balance represents funds received tax free into the "marital pot" that were used to acquire a marital asset.
4. Since B will repay the $20,000 with after-tax dollars, essentially she is paying A's tax on half the $20,000 - that is, $10,000. At a 25% combined federal-state rate - it's $2,500. Shouldn't B receive a credit for this assumption of A's half of tax that is, substantively, a marital obligation?
5. We often tax affect retirement benefits when they are divided unequally. But, that is not typically done if a retirement benefit is divided equally - as in the example.

Take Away

Give the above due consideration if representing a plan participant who will be responsible for repaying a plan loan which provided funds spent for marital purposes.

About the Author

__Joe Cunningham__ has over 25 years of experience specializing in financial and tax aspects of divorce, including business valuation, valuing and dividing retirement benefits, and developing settlement proposals. He has lectured extensively for ICLE, the Family Law Section, and the MACPA. Joe is also the author of numerous journal articles and chapters in family law treatises. His office is in Troy though his practice is statewide.