# Overview of the Division of Retirement Benefits in Divorce – Part 2

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The following is a continuation of the materials presented in the March 2015 Tax Trends column.

## III. Defined Contribution (DC) Plans

A. A DC plan–such as a 401(k) plan – provides for **separate account** for each participant.

1. E.g.–W's account balance under the XYZ 401(k) plan was $50,000 on December 31, 2014.
2. Other types of DC plans include profit-sharing plans, money purchase pension plans, and 403(b) annuities.

B. **Division of DC plan accounts** is also accomplished either by the offset method or by deferred division using a QDRO/EDRO.

C. **Offset method – Valuation**

1. The present value of the DC plan interest is generally considered its **account balance** as of the valuation date. See above for an example.
2. As with the present value of pensions under DB plans, it is typically appropriate to **tax affect** the value of the account balance.
3. It is important to specify a **valuation date**, generally close to when other assets will be divided.
4. If there is a **plan loan**, the account is (1) valued net of the loan and (2) responsibility to repay the loan is assigned to the participant.

Example:

- The total pre-tax value of W's 401(k) account is $50,000 - $40,000 of plan investments and (2) a $10,000 loan she drew from the plan.
- Equal division under the offset method:

| | H | W | Total |
|---|---|---|---|
| Plan Investments | 40,000 | | 40,000 |
| Plan loan | 10,000 | - | 10,000 |
| Total | 50,000 | | 50,000 |
| Federal & state tax at 20% | (10,000) | | (10,000) |
| Loan obligation | (10,000) | - | (10,000) |
| Sub-total | 30,000 | - | 30,000 |
| Offsetting other property | - | 30,000 | 30,000 |
| Equal division | 20,000 | 20,000 | 40,000 |

D. **Deferred division method – QDROs/EDROs**

1. QDROs/EDROs for assignment of parts of DC accounts are less problematic than those for DB plan pensions. Watch points include:

   a. It is necessary to specify the valuation date as of which the assigned interest is to be segregated in a separate account for the alternate payee.

   b. It should be provided that the assignment of benefits to the alternate payee will not be affected by **participant's death** before the assigned interest is segregated in an account for the alternate payee.

   c. It is also important to expressly provide in the QDRO whether the alternate payee's assigned interest will be proportionately **adjusted for earnings/losses** in plan investments from the date of segregation through distribution to the alternate payee. Sample language for so providing is as follows:

   "The Alternate Payee is entitled to any gains or losses on the award from January 1, 2015 to the date of actual distribution. However, the Alternate Payee is not entitled to share in any contributions to the Participant's account, if any, or

earnings thereon, made after January 1, 2015 by the Participant or by his employer. The Alternate Payee shall receive benefit payments under the Plan in the form of a lump sum distribution as soon as administratively possible."

d. The following is sample language providing for treatment of any **plan loans**:

"In the event there is an outstanding loan balance as of the valuation date, the loan balance will not be included for purposes of calculating the account balance to be divided. The Alternate Payee's award will be paid from the non-loan assets in the Participant's account on the date that the award is segregated from the Participant's account. The Participant shall maintain full responsibility for repayment of any and all outstanding loan balances holding the Alternate Payee free and harmless thereon."

2. Most DC plans allow–and some require–that the alternate payee's assigned account to be distributed as a lump sum to him/her as soon as administratively feasible after approval of the QDRO.

3. Alternate payees are taxable on such distributions in the year received.
   a. But, under IRC Section 72(t)(2)(C), distributions to alternate payees of funds assigned by QDRO are not subject to the 10% penalty tax generally applicable to qualified plan distributions to recipients not yet 59 ½ years of age.
   b. Alternate payees have three options for tax purposes when taking a distribution from a plan pursuant to a QDRO:
      (1) Pay the regular tax on the distribution.
      (2) Roll the entire amount over to an existing or newly established IRA to avoid current taxation. A "direct rollover" from the plan to the IRA should be arranged with the Plan in advance.
      (3) Retain part of the distribution, which will be taxed, and roll the balance into an IRA.
   c. If part or all of a distribution is rolled into an IRA, it becomes subject to normal IRA taxation, including the 10% penalty if withdrawn before age 59 ½.
   d. Thus, the period directing following divorce provides a "window" for alternate payees to access funds subject to regular tax but not the additional 10%.
   e. **Practice Pointer** – Attorneys should advise clients who will receive an interest in a plan pursuant to a QDRO of the need to consult with both (1) a tax advisor and (2) an investment/financial advisor.

4. Because of the exclusion from the 10% penalty tax and, further, because alternate payees are not uncommonly in relatively low tax brackets the year of divorce, 401(k) accounts can be used advantageously for one or both parties.
   a. **Practice Pointer**–Whenever a 401(k) account of significant amount is involved in a divorce, think "out of the box" for how it might be used to benefit one or both parties.
   b. If a "closely-held" company plan is involved, it may be advantageous to **split the distribution into two years.**
      (1) E.g. Half in the year of divorce and half the following January.
      (2) This may avoid the higher tax brackets that may apply if the distribution was 100% taxable in one year.

## IV. IRAs

A. An IRA – in part or in total - may be transferred to a spouse/ex-spouse tax free pursuant to a divorce settlement under IRC Section 408(d)(6).

B. **QDROs are not used** for divorce related IRA transfers.
   1. Rather, financial institutions administering IRAs have specific assignment forms for divorce related IRA transfers.
   2. As with distributions from qualified plans to alternate payees, the transferee of a divorce related IRA transfer should arrange in advance for a **direct rollover** into his/her existing or newly established IRA.

C. The transferee spouse is then **subject to the general tax rules** applicable to IRAs on the transferred IRA, including the 10% penalty for withdrawals before age 59 ½, unless disabled.
   1. IRC Section 72(t)(A)(iv) excludes from the 10% penalty **equal payments** made not less frequently then annually **over the taxpayer's life expectancy** regardless of his/her age.

      Example
      - W is awarded $150,000 from H's 401(k) as a partial offset to the value of his waste management business, which she rolled into a new IRA.
      - She is 55 would like to supplement her income until age 59 ½ when she can begin drawing on the IRA without penalty.

- Since her life expectancy is 30 years, she can withdraw $5,000 a year without the penalty. Once she begins to do so, she must continue to draw the $5,000 annually at least until age 59½.

2. **Practice Pointer** – This little known exception to the 10% penalty can be used to provide extra annual income.
3. IRC Section 72(t)(E) excludes from the 10% penalty amounts drawn to pay for **"qualified higher education expenses."**
   a. "Qualified higher education expenses" include tuition, books, fees and supplies required for enrollment at an eligible education institution.
   b. Room and board also qualify for students enrolled at least half time.
   c. The expenses include those incurred by the taxpayer, a spouse, or child.
   d. **Practice Pointer** – Thus, IRA funds may be available for costs of a spouse's education post-divorce and/or for that of a child. The funds will be taxable to the owner of the IRA but not subject to the 10% penalty.

## V. Timing

A. **Prompt attention** to documents necessary to make divorce settlement transfers of retirements is highly advisable.

1. Certainly it serves client well to wrap this item up along with the rest of the divorce settlement.
2. It also **avoids knotty problems** that may arise if the other spouse dies before a QDRO is entered, particularly if he/she has remarried.
3. It is good practice to have the QDRO or IRA forms prepared at or soon after entry of judgment.

## 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.*