TAX TRENDS AND DEVELOPMENTS

QDROs Present a Tax-Smart Option Following Elimination of Section 71 Alimony Deductions

By Joseph W. Cunningham, JD, CPA

With the elimination of taxable/deductible Section 71 payments effective January 1, 2019, using a QDRO transfer of an interest in a defined contribution plan (e.g., 401(k), 403 (b) account) by which a business owner spouse buys out the other spouse's marital interest is a good fit in many situations.

General

In the past, Section 71 payments provided a means by which one spouse could buy out the other's marital interest in a business with pretax dollars. But, with the 2017 Tax Cuts and Jobs Act of 2017 repeal of the alimony deduction, this method is no longer available as of January 1, 2019.

However, use of a transfer of an interest in a defined contribution plan account via a QDRO can be a "tax-smart" way to structure a business buy-out.

Example

- H, 45 years old, owns ABC Company (ABC) which has been valued at $250,000 for his and W's divorce settlement.
- However, there are not sufficient other suitable marital assets to award W to offset the $250,000 business value.
- But, H has a 401(k) account with a balance of $400,000.
- His tax savvy lawyer proposes that H use his half of the 401(k) account to buy out W's $125,000 interest in the business.
- He tells H that he has the (1) business and (2) many years to replenish his 401(k) account for his future security.
- He adds that, by using the 401(k) account, He will not need to use his personal cash or that of ABC for the buy-out.
- Further, he states, since W no longer has the business as part of her future security, receiving additional 401(k) funds is ideal for her.
- Since the $250,000 business value is largely after-tax and the 401(k) account is 100% pre-tax, the transfer to W must be tax affected.
- So, assuming W federal and state tax rate will be 20% when she draws the 401(k) in the future, H transfers via a QDRO $156,250 of his $200,000 share of the 401(k) to W, the equivalent of $125,000 after-tax.

Observations

1. Avoiding using cash for the buy-out may be particularly beneficial if H has spousal and/or child support obligations.
2. Use of part of a 401(k) can also be used to buy-out an alimony obligation, as follows:
    - The present value of the projected stream of spousal support payments is calculated.
    - Then, the 401(k) amount is tax affected at the recipient's tax bracket to its after-tax equivalent similar to what was done in the example.
    - The recipient can access the transferred amount from the 401(k) without the 10% penalty regardless of either parties' age.

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.*

Email: JoeCunninghamPC@gmail.com

Website: https://JoeCunninghamPC.com