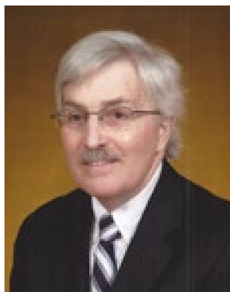

Flexible Use of Funds in a Defined Contribution Plan

E.G. – 401(K) – Received Via a QDRO in a Divorce Settlement

By Joseph W. Cunningham, JD, CPA

Receipt of an interest of a defined contribution (DC) plan pursuant to a QDRO can provide funds to serve many purposes on a relatively low-cost basis. DC plans are also referred to as "account balance" plans.

First, most such assignments of an interest in a DC plan – such as a 401(k) or savings plan – can be drawn as a lump sum distribution.

Second, such distributions are not subject to the 10% federal penalty tax applicable to distributions payable to someone under 59.5 years old.

Third, the recipient of such a distribution has 3 options regarding the funds:

1. Pay regular tax on the distribution.
2. Roll the distribution into an IRA – either existing or newly created – so that the funds can grow tax-free until later drawn out, usually at retirement
3. A combination of options 1 and 2 – that is, pay tax on part of the distribution while rolling the balance into an IRA.

The above sets the stage for some creativity when there is a need for cash.

Example 1

- The wife (W), 40 years old, receives $50,000, half of H's $100,000 401(k) account balance, via a QDRO assignment.
- She needs $15,000 to pay her attorney.
- So, she rolls $32,000 into an IRA, pays $3,000 tax on the other $18,000, netting the $15,000 she needs for attorney fees.

Example 2

- H and W owe $20,000 of credit card debt.
- W has a $100,000 401(k) account balance.
- She transfers $62,500 to H via a QDRO, retaining $32,500.
- Their divorce settlement provides (1) that H is solely obligated to pay the credit card debt; (2) that he will do so within 5 business days of receiving the 401(k) distribution; and (3) that he will provide documentation of the payment to W within 5 days thereof.
- H rolls $32,500 into an IRA, pays $5,000 tax on $25,000, netting the $20,000 needed to pay the credit card debt.

The above are simple examples of strategic use of DC plan funds in a divorce settlement. The uses are as varied as the cash needs of divorcing parties – such as a down payment on a new condominium, paying student loans, college expenses, etc.

It is noteworthy that:

- Once DC plan distribution funds are rolled into an IRA, they are no longer exempt from the 10% penalty tax if withdrawn before age 59.5.
- Regarding rolling some or part of a distribution into an IRA, it is highly advisable to arrange in advance for a "trustee-to-trustee" transfer directly from the plan into the IRA.
- DC plans will generally withhold 20% federal tax on lump sum distributions. This can be avoided if a "trustee-to-trustee" transfer is arranged in advance.

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.*

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