BY MARY KAY FOSS, CPA

Breaking Up

Income Tax Aspects of Retirement Plan Divisions

The family home and retirement plans are often the two largest assets a couple getting divorced must divide. The general rule is that there are no income tax consequences when dividing marital assets. When it comes to retirement benefits, however, care must be taken since these benefits are highly taxed.

Anti-alienation Provisions, Qualified Plans

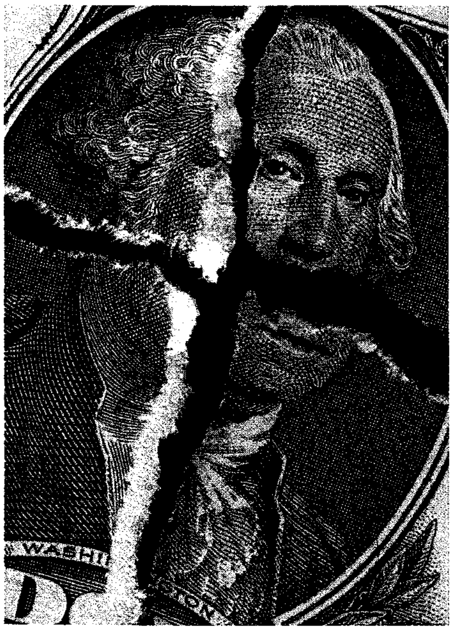
Since Jan. 1, 1976, a qualified plan must provide that benefits may not be assigned alienated, garnished, etc.—with certain exceptions. The rules prohibiting the assignment or alienation of benefits do not apply to the payment or assignment of a benefit payable with respect to a participant under a domestic relations order (DRO) that is determined to be a qualified domestic relations order (QDRO).

With these rules, the employed spouse is the plan participant, and the spouse that expects to receive benefits is the alternate payee. This language distinguishes the spouse or former spouse from other creditors.

Attorneys usually draw up a DRO that specifies an amount and a procedure for dividing the benefits. The order is forwarded to the plan administrator, who must determine that it's in compliance with the qualified plan. A QDRO cannot require that the benefits be paid in a form not specified in the plan, or that the alternate payee receive increased benefits. A DRO that cannot be qualified because it conflicts with the plan is sent back for revisions.

A QDRO is a judgment, decree or order that:

(a) relates to the provision of child support, alimony or property rights to a spouse, former spouse, child or other dependent;
(b) is made under a state's community property or other domestic relations law; and
(c) creates or assigns all or a portion of a participant's plan benefits to the spouse, former spouse, child or other dependent of the participant.



> Generally, there are no income tax **consequences** when dividing marital assets.

Within certain limits, the QDRO can allow the alternate payee to begin receiving benefits as of the participant's earliest retirement age.

The Pension Protection Act of 2006 (PPA) dealt with some unanswered questions relating to payments to a former spouse incident to divorce. Many DROs are not "qualified" when initially presented, and the QDRO rules didn't provide specific guidance in such a situation. This created problems, especially if the plan participant remarried before the amount due to the alternate payee had been determined.

The PPA directed the Department of Labor to issue regulations on QDROs to clarify that a DRO that meets QDRO requirements won't fail to be treated as a QDRO solely because the order is issued after or revises another DRO or QDRO, or because of the time it was issued.

Dividing an IRA

A transfer to a spouse of a portion of an employer's profit sharing distribution received upon retirement, or part of the balance in an individual retirement account, is taxable to the transferring spouse under IRA rollover rules—unless the transfer is incident to a divorce. The general nonrecognition provisions do not prevail over the specific IRA provisions [Internal Revenue Code Sec. 408(d)(6)].

The transfer of an individual's interest in an IRA to his or her spouse or former spouse under a divorce or separation instrument described in IRC Sec. 71(b)(2)(A) is not a taxable transfer. The individual's interest at the time of the transfer is treated as an IRA of his or her spouse, and not of the individual. Thereafter, the IRA is treated as maintained for the benefit of the spouse.

The division is pursuant to Sec. 408(d)(6); a formal QDRO is not required. Splitting an IRA upon divorce is less complicated than dividing a qualified plan. In fact, before the QDRO provisions were enacted, there were cases in which qualified plans were amended to allow early distributions that could be rolled into separate IRAs and divided tax free (Private Letter Ruling 8336085).

The transfer must be made pursuant to a valid divorce decree or written instrument incident to the divorce. If the entire IRA is to be conveyed, the owner may execute a separate document that assigns his or her ownership rights to the ex-spouse. For partial transfers, the assets to be conveyed can be withdrawn or rolled over to another IRA assigned to the ex-spouse.

The owner also can arrange for a direct transfer of assets by the IRA custodian or trustee to the sponsor of an IRA established and owned by the ex-spouse.

Breaking Up

QDRO Transfer

After a QDRO transfer, the balance credited the alternate payee spouse or former spouse pursuant to a QDRO may be treated as a lump-sum distribution—provided that the amount would have been a lump sum had it been paid to the participant. The special tax treatment available to lump-sum distributions (10-year averaging, capital gains and net unrealized appreciation of employer securities) is available. The QDRO payment can also be rolled over into an IRA. Any basis (investment in contract) in the plan is allocated pro-rata between the QDRO and the present value of all other benefits payable with respect to the participant.

Since 2001, a qualified plan's basis can be rolled over into an IRA, which allows the entire QDRO distribution to be rolled over. If the plan's proceeds are not rolled over, they are not subject to the 10-percent penalty on early distributions discussed below.

Absent a QDRO, payments made to a spouse or former spouse are taxed to the plan participant, as are payments made to an alternate payee that is not a spouse or former spouse.

Transfers From an IRA

After the transfer, the ex-spouse treats the account as if he or she had owned it initially. So, an ex-spouse over age 70.5 must begin immediate withdrawals. Any basis that the original owner had in the account transfers to the former spouse. Withdrawals before age 59.5 could be subject to a 10-percent penalty.

Penalty Treatment

There are few exceptions to the tax on early distributions—better known as the Sec. 72(t) penalty, or the 10-percent penalty—before age 59.5. Some exceptions relate to items that are excluded from the definition of early distributions, such as QDROs, inherited plan benefits or IRAs and payments from a qualified plan after age 55 at separation of service. Be aware that QDRO payments are no longer exempt from the 10-percent penalty if they are rolled over into an IRA.

Also note that California imposes a 2.5-percent penalty whenever the federal 10-percent penalty applies.

Many alternate payees will need to rely on the following exceptions from this penalty:

- Early distributions from qualified plans, IRC Sec. 403(b) arrangements, IRAs or SEPs that are used to pay deductible medical expenses. The recipient need not itemize deductions to claim this exemption, but only expenses in excess of 7.5 percent of adjusted gross income are free of the penalty tax.
- Withdrawals by unemployed persons to pay medical insurance premiums. The 10-percent penalty will not apply if the individual has received unemployment compensation for 12 consecutive weeks and the withdrawal is made in the year the benefits are paid or in the subsequent year.
- IRS levy withdrawals. However, withdrawals to pay taxes or to induce the IRS to release a levy on property do not qualify for the exception. Bankruptcy withdrawals are subject to the penalty.

There is no penalty for early withdrawal of IRA funds for first-time homebuyers and qualified higher education expenses incurred by the IRA owner, spouse, child or grandchild of the owner or spouse.

The first-time homebuyer exception is subject to a lifetime limitation of $10,000 and does not apply if any other exception under Sec. 72(t) could apply. The distribution must be used within 120 days for qualified acquisition costs of the principal residence of a first-time homebuyer. The first-time homebuyer can be the IRA owner, spouse, child, grandchild or ancestor of the IRA owner or spouse. Qualified acquisition costs are defined as the cost of acquiring, constructing or reconstructing a residence—including reasonable settlement, financing or closing costs. For this purpose, principal residence follows the Sec. 121 definition.

A first-time homebuyer is an individual who has had no present ownership in a principal residence during the two-year period ending on the date of acquisition.

The qualified higher education expenses exception does not apply if another exception under Sec. 72(t) is available. In addition, the amount of higher education costs qualifying for the Hope and Lifetime Learning Credits is reduced by amounts exempted from the 10-percent penalty. Tuition, fees, books, supplies and required equipment are considered qualified higher education expenses. Room and board at a post-secondary school also qualifies when the student is at least half time.

The withdrawal and the payment of the qualifying higher education expenses must occur in the same year. The use of the IRA to pay off prior-year credit card charges or student loans for higher education does not qualify for the exception.

Other exemptions from the penalties on early distributions include:

- Distributions due to disability. It is important to remember that the definition of disability for penalty tax purposes is much more severe than under many disability insurance policies [Sec. 72(m)(7)].
- Distributions that are part of a series of substantially equal periodic payments over life expectancy, made at least annually over the life expectancy of the IRA owner (or joint lives of owner and designated beneficiary), are exempt from the 10 percent additional tax on distributions received before age 59.5. Payments must continue for at least five years, or until age 59.5—whichever is the longer period.

The periodic payments exception carries conditions. The IRA owner is prohibited from changing the method of distribution for at least five years, even if the owner reaches 59.5 before the five-year period ends. The method can only be changed if the owner dies or becomes fully disabled. In addition, the IRA owner may not contribute additional funds to the IRA or take any distributions other than those required to avoid the penalty.

If the IRA owner relies on the substantially equal payments exception and fails to satisfy the exception, then a recapture tax applies. This tax is paid in the first year that a modification occurs and is 10 percent of all distributions received before age 59.5, plus interest.

If the IRA owner dies before receiving substantially equal installments for all five years, the recapture tax is not applicable. Similarly, a modification of payments due to disability will not trigger the recapture tax.

The rules for taxing retirement plan and IRA distributions are straightforward, but fraught with errors based on the number of Tax Court cases that result from them. Be aware of the income tax rules and how to avoid penalties when dividing these plans.

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