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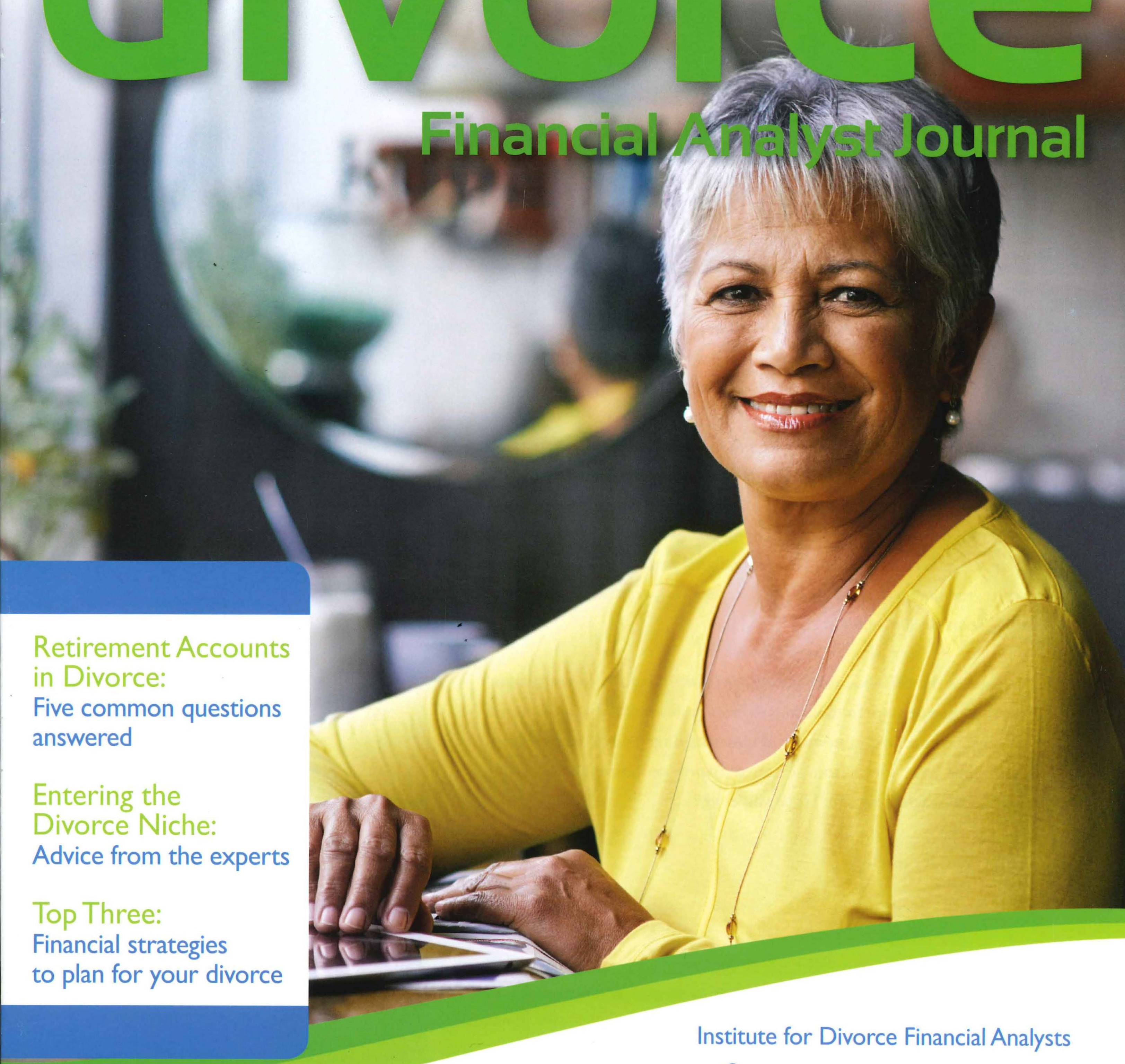

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Five common questions answered

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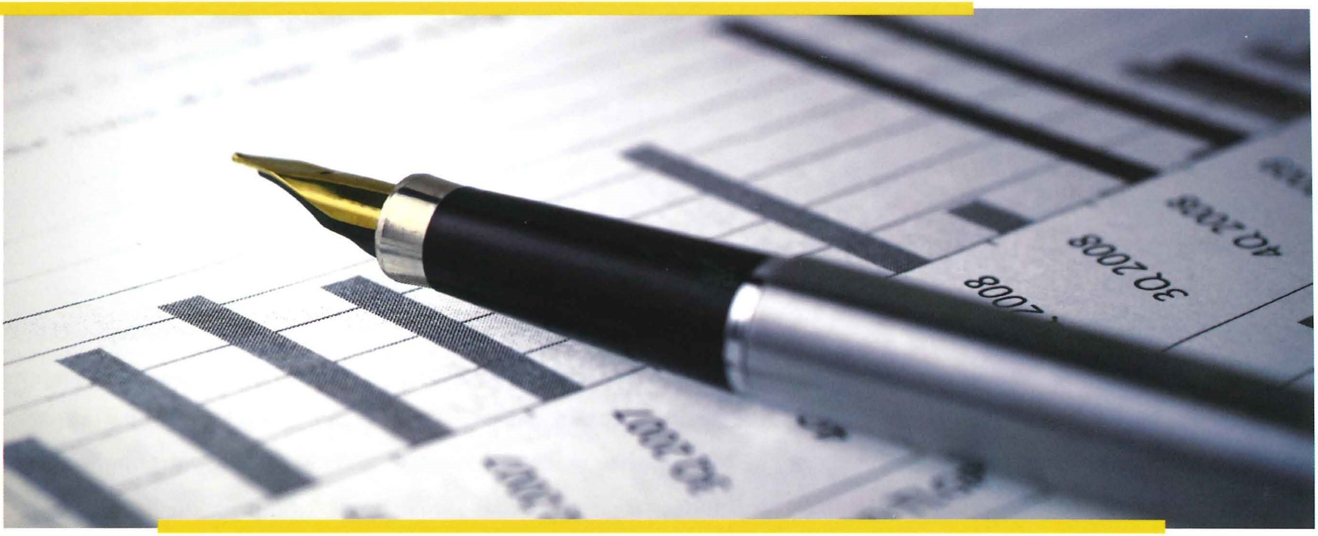

Retirement Accounts in Divorce: Five Common Questions

Pam Friedman, CFP, CDFA

Retirement accounts are complicated, especially in divorce. Here are some questions you may run into.

Can a retirement account be divided without triggering taxes?

A tax-free division is possible, but each plan or account has different requirements. Before signing any agreement in divorce, consult with each plan administrator (or account custodian) to properly analyze the process needed for a tax-free division. Without the right process, clients may be subject to significant taxes, penalties, and ultimately an inequitable division.

While the division of marital property generally is governed by state domestic relations law, any assignments of qualified retirement interests (for example, a 401(k) plan) must also comply with Federal law, namely the Employee Retirement Income Security Act of 1974 (ERISA) and the Internal Revenue Code of 1986 (the Code).

A qualified retirement plan will require a Qualified Domestic Relations Order (QDRO or "Quadro") to divide the investments in the account. If prepared properly, the QDRO outlines every detail of the split so the plan administrator can complete the transaction accurately.

Attorneys might downplay the need for a QDRO specialist because they often use standardized QDROs made available by plan administrators. However, these templates may not include all of the options for division. A QDRO specialist can help assure the QDRO is prepared accurately and money is divided in a timely fashion.

Non-qualified retirement plans, such as many traditional IRAs or Roth IRAs, may not require a QDRO. Many of these plans require a copy of the divorce decree and custodian specific forms to divide the account.

Is a retirement plan more or less valuable when compared to other assets?

Retirement assets are only one part of a family's total financial picture. In divorce, unnecessary expenses and taxes can be avoided. Moreover, liquidity is key to starting a financial life over again. CDFAs should rate each asset for liquidity and tax consequences to help match the division to the client's financial goals and priorities.

Most retirement plans rank lower than other assets because withdrawals are taxed at the owner's highest marginal tax rate and incur a 10% penalty until age 59.5 (although there are exceptions).

What about the sale of a home? Assuming there is a market for the home, home sale proceeds nearly always rank high on the list of desirable assets. A large share of gain from the sale of a primary residence (after closing costs are paid) is not taxed and, unlike most retirement plans, these proceeds are available to divorcing clients before age 59.5 without penalty.

Cash savings and checking accounts are, obviously, the most liquid. Brokerage and investment accounts rank in-between home sale proceeds and traditional IRAs because they are available for withdrawal and only investment gains are taxed.

Is a retirement account separate property?

Separate property is a legal concept that varies from state to state, so state law and precedent will guide the financial analysis needed to determine the separate property portion of accounts.

Generally speaking retirement benefits earned by either spouse during marriage can be divided, even if those benefits have yet to be realized. A CDFA can assist attorneys by gathering relevant documents and plan contact information and by being familiar with the coverture fraction. The coverture fraction is used to calculate the community share and is defined as the ratio of the married years of earning the benefit and the employed spouse's total earning period.

Can you avoid the IRS penalty for early withdrawal in divorce?

When the receiving spouse is awarded a share of a qualified plan like a 401(k), the share is most often moved to an alternate payee account inside the plan. Under IRS rule 72(t)(2)(C), the alternate payee of a qualified plan can withdraw pursuant to divorce without early withdrawal penalties (10%), but ordinary income taxes will still need to be paid. For a spouse with little or no income in the first year of divorce, this can be a source of liquidity to support his or her lifestyle.

The plan administrator will often withhold 20% because the alternate payee will be required to pay marginal taxes on any withdrawal. The more the spouse withdraws, the higher taxes owed.

Since every situation is unique, consult a CPA about the intent to use a penalty-free withdrawal before signing a settlement agreement. The alternate payee can often use a two-step withdrawal process to avoid penalties. First, withdraw the cash needed and then either (1) leave the remaining proceeds in the alternate payee account or (2) roll over the account to a new IRA. At the end of the year, the recipient spouse should receive a 1099 from the plan administrator for the withdrawal which indicates the 72(t)(2)(C) exemption.

Should you "tax affect" retirement accounts when dividing assets in divorce?

Many attorneys will "tax affect" retirement plans - discounting the account by the recipient's highest marginal tax rate. Left unchecked, the spouse receiving more of the retirement accounts may benefit (possibly unfairly) in negotiations from this practice.

In order to properly "tax affect" each plan or account based on economics, the parties would need to know when and how much will be withdrawn, future tax rates for each party, and the rate needed to discount the tax expense back to today's dollars – even when the recipient is very close to retirement.

By preparing financial projections, a CDFA can assess the amount and timing the recipient's anticipated withdrawals from retirement accounts. By discounting the future tax expense, the analyst can assess whether and how much to "tax affect" or discount the value of retirement assets. But I must warn you, attorneys who regularly "tax affect" retirement accounts to benefit their client's position in negotiations may not appreciate this kind of financial analysis.

Conclusion

Valuing and dividing retirement accounts is more complex than most divorcing couples expect. CDFAs can provide strategic ideas to help divide these accounts efficiently and avoid unnecessary costs.

About the Author

Pam Friedman, CFP, CDFA is the Founder of Divorce Planning of Austin and a Partner at Silicon Hills Wealth Management. She is the author of *I Now Pronounce You Financially Fit: How to Protect Your Money in Marriage and Divorce*, published by River Grove Books and available December 2015.

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