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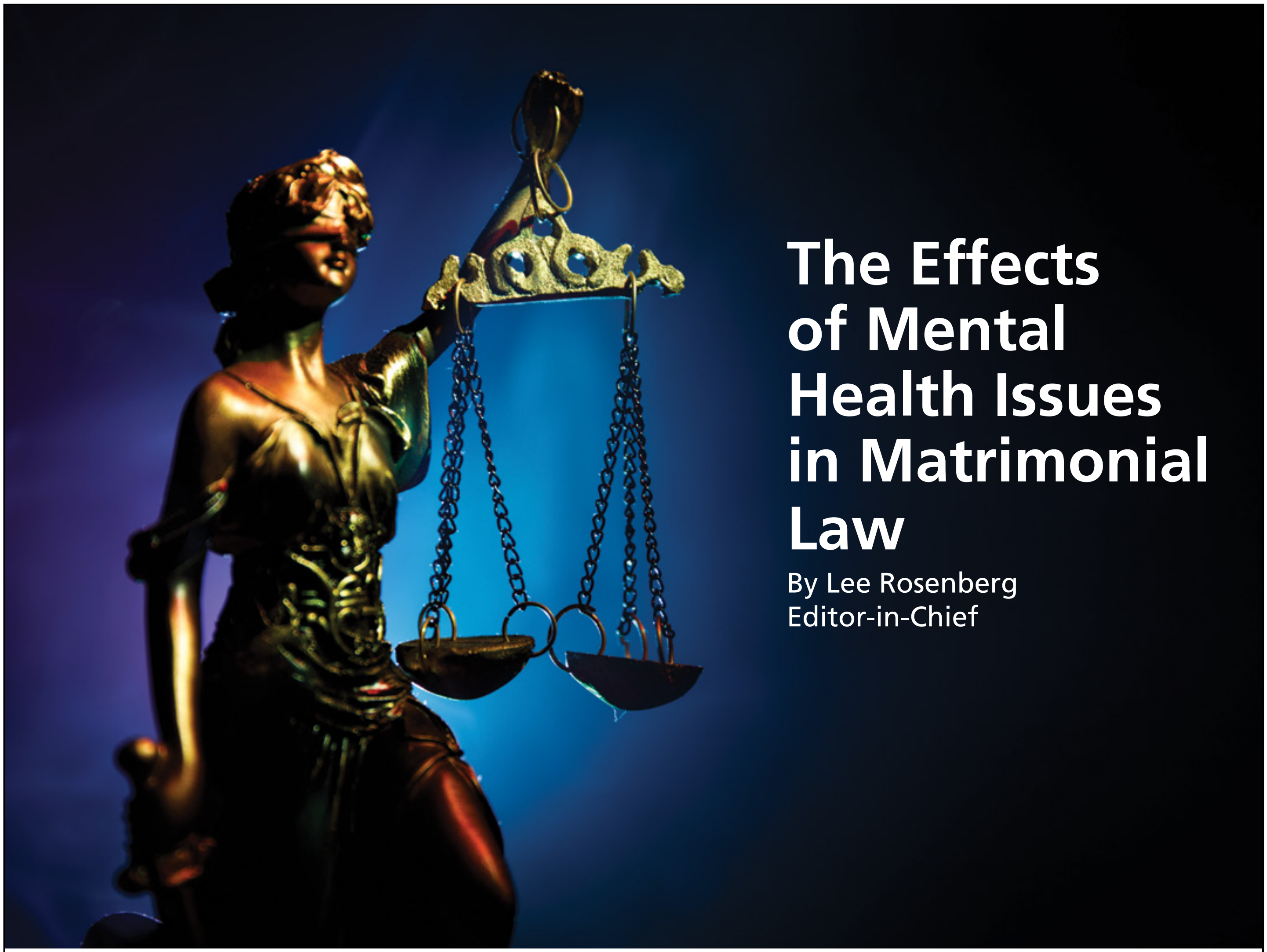

The Effects of Mental Health Issues in Matrimonial Law

By Lee Rosenberg
Editor-in-Chief

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Hidden Gems Within the Internal Revenue Code Offer Great Opportunities for Much Needed Liquidity in Divorces

By Denisa Tova-Liebman

In a commonly cited Private Letter Ruling, depending on your point of view the IRS either brightens or clouds this pretty gray area. A retired husband with several IRAs separated from his wife. The couple entered into what they felt was a separation agreement under which the IRAs would be divided equally with no penalties or taxation. They sought the IRS ruling that ultimately stated that these transfers *would* be taxable to the husband since the separation agreement did not meet the standards of I.R.C. §408(d)(6). It appeared the agreement did not stipulate that the couple was "legally separated," nor did it state the couple would ultimately present this to the courts to obtain a divorce decree. It would seem the couple was simply choosing to separate and live apart without sufficient legal documentation to confirm that arrangement.[1]

Cash is king in divorces! Marital home and retirement assets generally are the two big elephants in the room that need to be dealt with in divorce. And, of course, neither homes nor retirement accounts exactly scream liquidity.

According to Investment Company Institute data, reported by *Pensions & Investment,* in the first quarter of 2018, Americans held a total of $28 trillion in retirement market assets.[2] In this article, we will discuss strategies for dividing 401(k)s and IRAs, two of the largest categories of retirement assets. Defined benefit plans or pensions fall in this category too, but that will be a worthy topic on its own for a future article. More important, we also will describe the unique planning opportunities (some relatively lesser known) that can be helpful to bring the settlement to the finish line. These strategies can be especially appealing for people under 59 ½ who need short-term cash and liquidity.

Is 50/50 Split Without Consideration of Risk a Good Deal?

Splitting up marital assets 50-50 sounds clean and simple but frequently that is far from the truth. As a divorce financial analyst, I often look beyond the numbers and consider things like the client's risk tolerance and financial savvy.

For example, Mary and John, both age 52, own a business, a marital home owned free and clear, a rental property and sizable retirement assets in John's name. They have little cash since they typically reinvest or sink it into the business. Mary does light bookkeeping for the business but is not involved, by choice, in the day-to-day operations. She expresses a need for security and does not feel comfortable with the risks associated with staying involved in the business or the management of the rental property. John, on the other hand, has a high appetite for risk and enjoys pursuing new business and investment opportunities. In order to achieve an equitable distribution, Mary will receive the bulk of the retirement assets and the marital home, while John will keep the business, the rental property and the remainder of his retirement accounts. The bottom line numbers may not exactly shake out 50-50 but it feels equitable to them and they both walk away happy.

Now to the Exotics and the Basics

Once it has been determined how to divide up retirement assets, the next consideration is how to implement the transfer. Some of the typical post-divorce needs that might warrant immediate access to cash are:

- Moving and home rental
- Making a down payment on a home
- Maintaining mortgage payments on a home
- Taking classes or earning a degree to prepare for re-entry into the work world
- Meeting living expenses

A financial divorce expert can develop a strategy for transferring retirement account assets to the non-titled spouse in ways that help him or her achieve these types of goals. Fortunately, the tax code creates windows of opportunity in which to make transfers and strategic distributions while avoiding penalties. But no one should be surprised that these opportunities and windows are different depending on whether one is dealing with an IRA or a 401(k)! Let's tackle IRAs first.

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IRA-Related Transfers and Distributions

General Guidelines

Unlike qualified plans, dividing an IRA does not require a Qualified Domestic Relationship Order (QDRO). We will present more on QDROs later in this article. The agreement or judgment should clearly lay out the terms of the division. The recipient spouse should receive his or her share of the IRA via a transfer or a rollover, rather than a distribution. However, if for some reason the funds are distributed rather than transferred, the recipient spouse will need to deposit the funds into an IRA or other qualified plan account within 60 days to avoid immediate taxation and the pre-59 ½ age, 10 percent early withdrawal penalty. From that point on the recipient assumes responsibility for managing the fund and all future tax liability.

That's the black and white…now let's look at one big gray area.

A Big Fat Question of Timing

When can this transfer happen? Most attorneys and CPAs instinctively say it immediately follows the issuance of a final divorce decree. But can a transfer occur earlier, say when a couple's signed settlement agreement is submitted to the courts? Must the couple indeed wait until the court responds with a divorce decree?

Before we broach that issue, why might an earlier division of an IRA be advantageous to the divorcing couple? The non-titled spouse may want this transfer to happen sooner (with the filing of the separation agreement) rather than later (upon receipt of the divorce decree) due to concerns about market volatility and movement that could affect the value of the account (more on that in the next section). More likely, a non-titled spouse may want or even need to take advantage of certain provisions described further below to add a distribution element to a transfer.

I.R.C. § 408(d)(6) governs the distribution of an IRA in a divorce. The statute states that all or a portion of an IRA can be distributed to a non-titled spouse's IRA without immediate tax consequences as long as there is a "divorce or separation instrument," which is defined in I.R.C. § 71(d)(2) as:

- a decree of divorce or separate maintenance or a written instrument incident to such a decree,
- a written separation agreement, or
- a decree (not described in subparagraph (A)) requiring a spouse to make payments for the support or maintenance of the other spouse.

Thus, it would seem that a transfer from an IRA account of a titled spouse to that of a non-titled spouse could occur as soon as the parties have entered into a property settlement agreement, spelling out the terms of their IRA division. In this case, the court is subsequently merely ratifying the agreement by entering a judgment. That could satisfy the requirement for "a written instrument incident to such a decree" related to a divorce or separate maintenance.

In this Private Letter Ruling,[3] does the IRS brighten or cloud this already pretty gray area? A retired husband with several IRAs separated from his wife. The couple entered into what they felt was a separation agreement under which the IRAs would be divided equally with no penalties or taxation. They sought the IRS ruling that ultimately stated that these transfers *would* be taxable to the husband since the separation agreement did not meet the standards of I.R.C. § 408(d)(6). It appeared the agreement did not stipulate that the couple was "legally separated," nor did it state the couple would ultimately present this to the courts to obtain a divorce decree. It would seem the couple was simply choosing to separate and live apart without sufficient legal documentation to confirm that arrangement.

But, erring on the side of caution, because penalties and tax consequences can be significant if there is a misstep, attorneys and financial experts will most likely continue to wait to transfer IRA funds until the final decree is issued. We can only hope this matter is further clarified in the near future through statutory amendments or legal rulings.

Locking in Value

If an early transfer of an IRA is not viable, there are at least two other ways to lock in the value of a fund early in the divorce process to protect a non-titled spouse from market fluctuations between the time of the signed settlement agreement and the divorce decree:

1. The agreement can stipulate a valuation date and whether the non-titled spouse will share any capital gains or losses between that date and the time of distribution.
2. The titled spouse can temporarily adjust his or her IRA account and reallocate funds to fixed instruments or even cash within that account.

These approaches can cut both ways, of course. If an account is primarily equity-based, and the market rises during that period, one or both of the parties likely will lose out on gains that might have accrued until the account gets divided. But again, accommodating the risk tolerance of both parties may create that extra incentive to successfully wrap up the settlement agreement.

Creating Liquidity Without Penalty: SEPPs

This next lesser-known strategy is available to the general public, not just the divorcing population. However, this planning tool can be especially helpful for late-in-life divorces (but pre-age 59 ½) where the couples' primary assets are tied up in retirement accounts and there is an immediate need for cash. As defined and described in I.R.C. § 72(t), a SEPP (Substantially Equal Periodic Payment) distribution arrangement is a way to tap into an IRA or an "old" 401(k) (from a previous employer) before age 59 ½ without an early-withdrawal penalty.

Under a SEPP arrangement, an account owner elects to receive regularly scheduled taxable payments (at least one per year) of fixed amounts over at least a five-year period or until he or she reaches 59 ½. The IRS offers three approved methods for calculating the required payment amount. The right method should be chosen that best meets the recipient's financial situation. Once the account owner reaches age 59 ½, he or she can stop the distributions until age 70 ½ when minimum required distributions must be taken.

A divorce situation triggers important SEPP-related opportunities for a non-titled spouse who needs immediate access to cash. A recipient can establish a SEPP distribution arrangement from his or her newly formed IRA or even possibly participate in a titled owner's ongoing SEPP.

> *Scenario: At the time of their divorce, John, the titled spouse of an IRA subject to transfer, is in the third year of a SEPP arrangement established to distribute $20,000 per year. Under the separation agreement, John will transfer 75 percent of the account to his ex-spouse, Sally.*
>
> *John has the opportunity at this time to reduce his SEPP distribution amount by 75 percent (to $5,000) or continue the current distributions at $20,000 (provide this will not prematurely deplete the reduced fund).*
>
> *Sally can initiate her own SEPP arrangement within her new IRA (or any other IRA she owns for that matter). She can also opt to assume the portion of the distribution that John may have chosen to forgo, i.e., $15,000. In that case, like John, Sally also would be in the third year of her SEPP arrangement. However, for her SEPP, Sally's age, not John's would dictate when the 59 ½ age threshold is reached.*[4]

401(k)-Related Transfers and Distributions

Divorce-related 401(k) fund transfers and distributions are guided not only by IRS statutes but ERISA (The Employee Retirement Income Security Act of 1974)[5] labor standards, reflecting the fact that these are workplace-based retirement accounts.

One important element that guides ERISA is the principle of "non-alienation": a participant's account cannot be transferred or given to anyone. Until ERISA was amended in 1984, this non-alienation clause conflicted with many state laws that sought to divide retirement plan accounts, including 401(k)s, in the course of a divorce. The 1984 amendments, found in the Retirement Equity Act,[6] allow for divorce-related 401(k) transfers provided they are done through a QDRO, that lays out specific conditions and restrictions for that 401(k) transfer.

QDROs are drafted by attorneys or other qualified specialists and subsequently "qualified" by the courts and the plan administrator as complying with the separation agreement, ERISA, and plan requirements. Among other things, a QDRO stipulates the applicable retirement plans involved and the amount of the transfer (either a dollar amount or a percentage).[7]

In short, when done in compliance with a properly executed QDRO, a 401(k) transfer will not be subject to penalties or taxation.

Timing

Unlike IRAs, there does not appear to be a hint of an opportunity to transfer funds early from a 401(k) since QDROs cannot be approved before the divorce decree. But a QDRO specialist can prepare the order as soon as a separation agreement is finalized, and divorcing couples should make sure this work is ongoing as they wait for a divorce decree so the QDRO can be executed as soon as possible after the decree.

However, there *is* a window of opportunity for an alternate payee to gain some liquidity during this ultimate transfer process. Under lesser-known provisions of I.R.C. § 72(t)(2)(c), an alternate payee can receive a portion of the transfer as a cash distribution penalty free if he or she notifies the plan administrator of that intention. This distribution is not tax free, however, and plan administrators will withhold 20 percent for that purpose.

> *Scenario: Jason is awarded 50 percent of his ex-wife Lori's 401(k) with a total value of $400,000. With a QDRO in place, Lori's employer contacts Jason to see how he would like the $200,000 dispersed. He advises the administrator he would like a $40,000 cash distribution with the remaining $160,000 transferred to his IRA. The administrator issues him a check for $32,000, withholding 20 percent to prepay taxes, and transfers the remaining $160,000 directly into Jason's IRA. Neither of these disbursements trigger the 10 percent penalty for premature 401(k) withdrawals as would otherwise be the case in a non-divorce situation.*
>
> *Alternatively, Lori and Jason could ask that the QDRO require the 401(k) account be divided within the plan (if the plan allows for it)—again, a non-taxable transaction. Jason would now be a participant in Lori's*

employer's plan, but he would not be able to make contributions or receive any matching employer contribution since he is not an employee there.

Follow Specific Steps or the Window to Avoid 10 percent Early Penalty Closes

Following the correct ordered processes is critical. If an alternate payee receives all the 401(k) funds as a transfer, he or she has lost the opportunity to immediately withdraw cash penalty free. Similarly, if a 401(k) is divided (i.e., shifted into a separate account within the same employer plan), an alternate payee cannot make a penalty-free withdrawal.

And Don't Forget 401(k) SEPPS

Finally, and as described in the IRA discussion, upon the transfer of the participant's 401(k) funds to the alternate payee's IRA, that IRA holder can initiate SEPP distributions. This is another, albeit rather roundabout, strategy to generate liquidity from a 401(k) transfer.

Conclusion

A solid divorce team, including an attorney and a qualified financial expert, can ensure that these commonly shared goals are met:

1. There is a fair and logical distribution of the marital assets reflecting as much as possible each person's risk tolerance and preferences.
2. The transfer of retirement account assets to the non-working spouse's retirement account(s) occurs tax and penalty free.
3. If necessary, the recipient spouse takes advantage of opportunities to create liquidity through disbursements made in conjunction with the transfers.

And, of course, the team should take advantage of all the opportunities buried deep in the IRS and ERISA statutes.

Endnotes

[1] Private Letter Ruling 9344027.

[2] http://www.pionline.com/article/20180621/INTERACTIVE/180629958/us-retirement-assets-at-28-trillion-in-q1-little-changed-from-end-of-2017.

[3] See endnote 1.

[4] Scenario based on information in *A Practical Guide to Substantially Equal Periodic Payments…*, William Stecker, pp. 86, 87.

[5] P.L. 93-406.

[6] P.L. 98-397.

[7] ERISA 206(d)(3)(C); I.R.C. 414(p)(2).

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