

VALUATION OBSERVATIONS

*Some practical observations from a practicing
business appraiser.*

VLLC

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Vol.5, No. 4

SPENDING MONEY FROM A QUALIFIED PLAN WITHOUT THE 10% PENALTY

Now that I have your attention, let's talk about how we can help our divorcing clients in need of cash when there seems to be no other way to get it. Normally, distributions made from a qualified retirement plan before the participant reaches age 59½ are called "early distributions" and are subject to a 10% penalty tax. The penalty does not apply to early distributions made pursuant to death, disability, annuity payments, or distributions made to an ex-spouse by a QDRO.

An exception under IRC §75(t)(2)(C) provides that the 10% penalty on early distributions from qualified plans does not apply to any distribution made to an alternate payee pursuant to a QDRO. Therefore, both the alternate payee who is a former spouse of the participant and the non-spousal alternate payee are not subject to the 10% penalty on early distributions. However, this does not apply to distributions from an IRA. Once the funds are in an IRA, this is no longer an option.

Who is an alternate payee? The term "alternate payee" means any spouse, former spouse, child or other dependent of a participant who is recognized by a domestic relations order as having a right to receive all, or a portion of, the benefits payable under a plan with respect to such participant. IRC §414(p)(8)

Former Spouse as Alternate Payee – An alternate payee who is the spouse or former spouse of the participant will be treated as the distributee of any distribution or payment made to the alternate payee under a QDRO. The effect of this provision is that the spouse/former spouse is responsible for any income tax liability resulting from the distribution of the QDRO benefit. The 20% income tax withholding rules are applied as if the spouse/former spouse of the participant is the employee. When a distribution is made from a qualified plan to a participant's spouse/former spouse pursuant to a QDRO, the spouse/former spouse is to be considered the "alternate payee" and to be taxed on the distribution as the distributee.

For purposes of the eligible rollover distribution provisions, any amount distributed pursuant to a QDRO to a spouse/former spouse alternate payee is treated in the same manner as if the distribution was made to the participant. Therefore, all or any portion of the QDRO distribution made to a spouse/former spouse alternate payee is eligible for rollover to an IRA.

Non-Spousal Alternate Payee – Distributions made pursuant to a QDRO during the life-time of the participant to a non-spousal alternate payee are included in the participant's income. Note that the IRS requires that 20% be withheld from the distribution as if the plan participant is the payee.

Because the QDRO distribution to a non-spousal alternate payee is includible in the gross income of the participant rather than the alternate payee, a non-spousal alternate payee may not rollover any part of the distribution.

To qualify for this exception, the domestic relations order must create or recognize the existence of the alternate payee's right to receive all or a portion of the qualified plan benefits, and *must be in existence before* the plan benefits are distributed. The distribution of the plan benefits to a party other than the alternate payee, or in advance of the finalization of the decree will not be considered made pursuant to a QDRO and will be subject to the 10% additional penalty tax.

Let's consider how this might work. Laura and Tom are divorcing at age 55. As part of the property settlement, \$300,000 will be transferred from Tom's 401-k to Laura's IRA.

If she transfers the funds directly to the IRA, she pays no taxes at all until she withdraws the funds from the IRA. But she has a cash flow problem. She needs \$60,000 to pay her attorney's fees and another \$20,000 to replace her roof for a total of \$80,000.

Because the 401-k withholds 20% to apply toward taxes on the withdrawal, Laura must request \$100,000. After the 20% withholding, she has \$80,000 in cash to pay her bills and the remaining \$200,000 will be transferred to her IRA. So long as this takes place pursuant to a QDRO, she is able to spend the \$80,000 without incurring the 10% penalty

If she waits until after the funds are transferred to the IRA before she makes her withdrawal request, she will be subject to not only the 20% withholding tax, but also the 10% penalty. That would cost her an additional \$10,000 unnecessarily.

It is important to understand the difference between *rolling over* money from a qualified plan and *transferring* money from a qualified plan. If money is transferred from a qualified plan to an IRA, the check is sent directly from the qualified plan to the IRA. In a rollover, the funds are paid to the person who then remits the money to an IRA.

A payment from a qualified plan to the person, whether or not there is a rollover, is subject to a 20% withholding tax, pursuant to The Unemployment Compensation Amendment Act. The withholding requirement can be avoided only by making a direct transfer.

If you would like additional information, or have a question, please do not hesitate to call.

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Terri Lastovka is the founder of Valuation & Litigation Consulting, LLC. Her practice focuses on business valuations and litigation consulting in the areas of domestic relations, gift and estate tax, probate, shareholder disputes, economic damages, and forensic accounting. She draws from a wide range of experiences, including public accounting, law, banking, and CFO. She has received extensive training from the American Society of Appraisers in the area of business valuation and works closely with members of the bar to effectuate practical settlements. Terri also serves as the Director of Legal & Finance for Journey of Hope, a grass roots non-profit organization providing financial support to cancer survivors.