

The Division of Retirement Plan Assets in Divorce

Understand the complexities of this important element of a divorce



Divorcing individuals may not want to think about retirement when they are negotiating the division of their marital estate, but retirement assets are typically one of the larger marital assets. The proper division of these assets in divorce can be extremely important to the financial future of each spouse.

Retirement assets include those assets held in workplace retirement plans as well as traditional Individual Retirement Accounts (IRAs) and Roth IRAs. Transferring retirement plan assets from one spouse to another is complicated due to the strict rules that govern the distribution of assets from any qualified plan or IRA. It's important to work with a qualified professional who has experience in the transfer of assets from qualified plans and IRAs. Retirement assets that are incorrectly transferred could be considered a full distribution of those assets and could incur considerable tax liabilities. The tax consequences can be severe: the distribution amount could be fully taxable as ordinary income and a 10% penalty could be assessed if the recipient is younger than 59 ½ years old, in addition to the regular tax.

Key takeaways

- While you may not want to think about retirement during a divorce, retirement assets are typically one of the larger marital assets
- Determining the proper division of retirement assets in a divorce and the actual distribution of these assets is very complex
- Each type of retirement asset must be handled in a different manner, so it's important to consult with your tax advisor

What type of retirement assets are involved?

The first step is to determine what type of retirement assets are held by each spouse. This is necessary because the tax characteristics of retirement assets can differ, as well as the rules governing the transfer of those assets. Put all "qualified plan" assets into one bucket and all IRAs into another bucket to start. Qualified plan assets originate from employer-sponsored plans and include 401(k)s, 403(b)s, and pension plans. From there, you can determine if there are Roth 401(k) assets as part of your qualified plan assets or Roth IRA assets as part of your IRAs. The Roth 401(k) and Roth IRA assets are after-tax savings vehicles so withdrawals from these accounts after the owner reaches the age of 59 ½ are not taxable to the owner. Ignoring the tax implications of withdrawals from each retirement asset could be a serious mistake. The non-Roth assets are pre-tax accounts and any distributions from these accounts in retirement will be subject to tax. Once the determination has been made regarding the type of asset and its taxability, negotiations can begin to determine a fair settlement.



Division of retirement assets

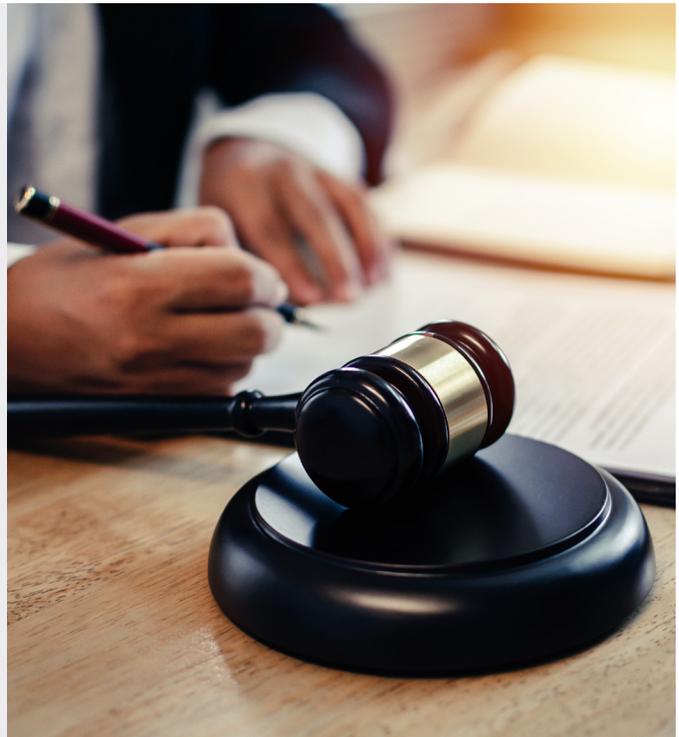
The divorce decree or property settlement agreement is an instrument that outlines the division of the assets to each spouse and there could be language in the instrument that specifically addresses the retirement assets. Many people think the divorce decree or property settlement agreement can be used to divide all of these assets but it can only be used to govern the division of assets held in a traditional IRA or Roth IRA. The inclusion of language in the divorce decree or property settlement agreement requiring the transfer of retirement assets in a workplace retirement plan is not sufficient to cover a spouse's rights to the assets. The division of retirement plan assets must be handled through a qualified domestic relations order, commonly known as a QDRO. A QDRO is needed to protect the interests of each spouse. Any transfer from a qualified plan pursuant to a divorce decree that is not deemed a QDRO is subject to tax and could be subject to penalty, and the transferor will be responsible for payment of the applicable taxes and penalties.

Terms of the QDRO

According to the Employee Retirement Income Security Act of 1974 (ERISA), a QDRO is a judgment, decree, or court order that creates or recognizes the existence of an alternate payee's right to receive all or a portion of a plan participant's benefits under an ERISA-qualified employee benefit plan. QDROs generally apply only to retirement assets held in workplace plans such as 401(k)s, 403(b)s, or traditional pension plans. Each QDRO must conform to specific rules determined by the plan administrator and no two QDROs are alike. A separate QDRO must be written for each plan that is to be divided or transferred. The plan administrator must approve the QDRO before the alternate payee is given any rights to the retirement account. The approval process is lengthy and it should be completed before the divorce is finalized. Once the QDRO is approved, the receiving spouse may roll QDRO assets into his or her own qualified plan or into a traditional IRA or Roth IRA. Be aware that a transfer of non-Roth assets into a Roth IRA will be taxable as a conversion but the transfer is not subject to an early withdrawal penalty.

What is a QDRO?

A QDRO, or qualified domestic relations order, is a judgment, decree, or order for a retirement plan to pay child support, alimony, or marital property rights to a spouse, former spouse, child, or other dependent of a participant.



Transferring a traditional or Roth IRA

The transfer or assignment of traditional IRA and Roth IRA assets are handled in a different manner, as these assets are not subject to ERISA rules. IRAs can be divided using a process known as “transfer incident to divorce” or through a domestic relations order. A “transfer incident to divorce” is commonly done through a custodian-to-custodian transfer and there are no tax consequences as a result of the transfer, provided the transfer was specifically required in the divorce decree or a property settlement agreement that is incident to the divorce decree. Any other transfers pertaining to separation or temporary support will result in a taxable transfer. While a domestic relations order is not required to transfer or divide a traditional IRA or Roth IRA, the use of a domestic relations order is recommended to give additional protection and help mitigate taxation on the transfer of the assets to the spouse.

It's important to understand that unlike the QDRO process with the qualified plans, IRA assets cannot be transferred or divided until after the divorce decree or property settlement agreement has been entered. The timing of any transfer of IRA assets is crucial. If the assets are transferred before the divorce is final and the original owner is younger than 59, he or she may be subject to income tax on the distribution amount

and a 10% early withdrawal penalty will be assessed. Once the transfer is complete, the recipient of the IRA assets will take legal ownership of the assets then assume sole total responsibility for the tax consequences of any future transactions or distributions. At this time the IRA owner will be subject to the normal distribution rules, which specify that distributions to the IRA owner aged 59 ½ or older are not subject to the 10% early withdrawal penalty. Distributions to the IRA owner younger than 59 ½ are subject to the 10% early withdrawal penalty unless the recipient qualifies for one of the exceptions to the penalty.

Beware of pitfalls when transferring assets before the divorce is final

There are some potential pitfalls that you should be aware of before assets are transferred and the divorce is finalized. First, it's important that the division of assets is determined based on a percentage of assets instead of a set dollar amount. The use of percentages may protect against market fluctuations and clarify the amounts to be received in the agreement. If set amounts are used in the agreement and the value of the assets increase or decrease based on the market, neither spouse is protected from the fluctuations. For example, suppose your IRA is worth about \$300,000 when the divorce decree is signed and your spouse is to receive \$150,000 of the IRA. The day



Hypothetical example of how division based on percentages may help protect against market fluctuations



Dividing by percentages

If your IRA is worth: \$300,000

Agreement:

50% to your spouse

50% to you

The market drops
and your IRA is now worth: \$200,000

50% to your spouse: \$100,000

50% to you: \$100,000



Dividing by dollar amounts

If your IRA is worth: \$300,000

Agreement:

\$150,000 to your spouse

\$150,000 to you

The market drops
and your IRA is now worth: \$200,000

\$150,000 to your spouse

Only \$50,000 to you

before the transfer is made to your spouse, the market declines and your IRA is now worth \$200,000. Based on the divorce decree or property settlement agreement, \$150,000 will still be transferred to your spouse. Had the divorce decree been written to state that your spouse was to receive 50% of the assets in your IRA account, then your spouse would receive \$100,000 when the transfer is made.

Another example illustrates the impact based on the increase in the value of assets. Suppose in this scenario that your spouse has an IRA worth \$800,000 and the divorce decree or property settlement agreement states that you are to receive \$400,000 of the IRA. A few days after the agreement is executed and before the funds are transferred, there is an increase of \$200,000 in the fair market value of the IRA, so now the total value of the IRA is \$1,000,000. Based on the agreement you will receive \$400,000 regardless of the value on the date of the transfer of the IRA asset. You have now lost out on the increase in value due to the market fluctuation. If the divorce decree or property settlement agreement had used percentages instead of a fixed dollar amount, then you would have received \$500,000 upon the transfer of the IRA. The use of percentages will help to mitigate any risk of your spouse getting an unequal amount of assets.

Next, determine the basis of any retirement plan or IRA assets held so that the basis is properly transferred upon the distribution of the retirement plan or IRA assets to the receiving spouse. The basis can be determined by how the contribution was reported for tax purposes. It's possible that nondeductible contributions were made to an IRA in prior tax years and there is basis in those contributions. Be sure to check your tax returns filed for Form 8606 and consult a tax advisor if nondeductible IRA contributions were reported.

Update your beneficiary designations

Finally, make sure to add or update your beneficiary designations on all retirement accounts to be sure that the intended recipients receive the assets upon your death, not your ex-spouse. Beneficiary designations are specific to each retirement account held so a separate designation should be completed for any account you hold. The distribution of retirement plan assets, whether held in a qualified plan or IRA, is not governed by your will, which makes it extremely important to review your beneficiary designations for each account upon executing a divorce. Be aware that due to ERISA's "spousal consent rule," the beneficiary designated

on your qualified retirement plan accounts must be your spouse unless your spouse gives written consent allowing a non-spouse beneficiary to be named; therefore, you will likely have to wait until the divorce is executed before changing the beneficiary. Traditional IRAs and Roth IRAs are not subject to the ERISA rules and the beneficiary can be changed by the account owner at any time by completing the proper forms provided by the custodian.

Determining the proper division of retirement assets in a divorce and the actual distribution of these assets is very complex. Protect yourself and your financial future by working with a qualified advisor who can help you navigate the intricacies of the division of retirement plan assets.

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