

Dividing Retirement Assets at Divorce

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For many couples, retirement assets represent a significant portion of net worth. During a divorce, in order to split assets equitably, most couples divide the benefits available in their employer retirement plans and the money they invested in their individual retirement accounts.

Court-ordered division of assets

The rules for splitting accounts are unique to each type of retirement account, but one rule is uniform: To avoid current taxation, the division of the retirement accounts must be done as a result of a court-ordered property division, divorce, or separation agreement.

- **Qualified domestic relations order (QDRO):** Before a traditional pension, 401(k), 403(b), or 457(b) plan can be divided, a document called a QDRO is needed. A QDRO is a court order that tells the retirement plan administrator how to divide the retirement assets. In the QDRO, the employee is referred to as the *participant spouse*, and the recipient of the assets is called the *alternate payee*. In lieu of a QDRO, some employers prefer to provide their own standardized form for court approval.
- **Transfer of account incident to a divorce:** IRAs, including traditional, Roth, SIMPLE, and SEP accounts, can also be divided by a court order. The term for dividing an IRA or nonqualified annuity between the IRA owner and the former spouse is a *transfer of account incident to a divorce*. Note that without the specific direction of a court-approved settlement, a transfer of part of an IRA to a spouse or former spouse will trigger taxes. The IRA owner, not the former spouse, is responsible for the taxes and any penalties due.

Separating the benefits

Retirement plans. As noted above, prior to making any changes to a participant spouse's plan benefits, employers require a QDRO document, signed by a judge. Before the QDRO is written and issued, it is a best practice to talk with your or your former spouse's retirement plan administrator about plan requirements. Once the QDRO is written, it takes a court order to make corrections or changes.

Depending on individual plan rules, benefits may separate immediately (the separate interest approach) or at the participant spouse's earliest retirement eligibility (the shared payment approach).

- With the **separate interest approach**, the alternate payee's benefits are assigned immediately but may not be accessible until a later date.
- With the **shared payment approach**, benefits for the alternate payee are available only when they become available to the participant spouse.

IRAs. Practices and requirements among IRA custodians differ. The key to a successful transfer is to have a settlement agreement that clearly specifies the accounts to be transferred. Under Internal Revenue Code Section 408(d)(6), this transfer is intended to be tax-free.

There are two basic ways to split up an IRA. The most common method of transfer is to **segregate the assets into a new IRA** for the former spouse. Alternatively, a check can be cut to the recipient spouse, who has 60 days to open his or her own IRA to avoid taxes.

Additional important details regarding QDROs

Employer plans can be categorized as *defined contribution*, like the popular 401(k) plans, and *defined benefit*, commonly called pensions. A defined contribution plan has readily ascertainable account balances. These are usually split shortly after a divorce has been finalized.

A defined benefit is typically paid as a monthly benefit at retirement. With the separate interest model, the former spouse is treated as an employee, and benefits are paid until his or her death. With a shared interest model, benefits usually stop at the participant spouse's death, even if the former spouse is still alive.

A former spouse qualifies for a survivor annuity only if the QDRO clearly provides it and the retirement plan can accommodate it. If the plan cannot provide survivor benefits to a former spouse, or if the former spouse's claim ends at the participant spouse's remarriage, the former spouse may consider life insurance as an alternative means of income.

If the QDRO specifies payout instructions not offered by the retirement plan, it cannot be honored; however, the QDRO can require early retirement benefits for the alternate payee even if the participant spouse chooses to delay retirement.

Unlike an alimony award, retirement plan property settlements are not generally severed when a former spouse remarries.

Tax issues

QDROs. Which party is responsible for taxes? It depends on whether a separate account has been set up for the former spouse or whether monies are paid out of the participant spouse's benefits. With separate accounts, each party is responsible for his or her own taxes. With shared benefits, all taxes are paid by the participant spouse.

Note that a QDRO-ordered distribution to a child or other dependent is always taxed to the participant spouse.

One of the advantages of a QDRO is that the 10-percent penalty does not apply for early withdrawals from a 401(k), 403(b), or 457(b) plan made to a former spouse who is younger than 59½; however, the mandatory 20-percent withholding tax does. To avoid the tax on monies intended for IRA rollover, elect a direct transfer to the new IRA custodian.

Divided IRAs. Remember that an informal or mediated agreement between spouses to divide individual IRA assets is not recognized by the IRS and will result in taxes. Also, unlike with QDROs, a divorce does not qualify as an exception to the 10-percent early withdrawal penalty for IRA distributions prior to age 59½.

Special situations

The former spouses of **military members** may receive up to 50 percent of the military member's retirement pay if the couple was married for at least 10 years. Because the military uses the shared benefit model, benefits to the former spouse begin only after the military member elects retirement. Benefits continue until the retiree's life expectancy, unless the retiree elects a survivor benefit plan. The survivor benefit can be lost if the former spouse remarries before age 55.

State, local, and municipal retirement systems offer fewer options for dividing marital assets. The retirement plans of some states do not allow the assignment of benefits, even to a former spouse.

Other types of government retirement benefits are the Federal Employees Retirement System (FERS) and the Civil Service Retirement System **programs for federal retirees**. The correct term for the division of assets of federal retirees is not QDRO but Court Order Acceptable for Processing. FERS also uses the shared benefit model, so a rollover to an IRA is unavailable.

Social security is available to former spouses who were married for more than 10 years. The rules for receiving benefits as a former spouse are the same as for current spouses. For example, if a former spouse reaches full retirement age, he or she will receive the higher of his or her own work-related benefit or 50 percent of the worker's full retirement benefit. At the worker's death, the former spouse can receive up to 100 percent of the decedent's social security benefit, reduced for the former spouse's early retirement. These benefits are available even if the worker remarries or if the former spouse remarries after he or she turns 60. Payments to former spouses do not reduce the worker's or the current spouse's benefits.

Nonqualified annuities can be divided between divorcing spouses without triggering taxes, based on the instructions of the court-approved settlement document. Because each insurance company has its unique requirements, it is wise to communicate with the carrier *before* the final divorce decree. You may find that existing surrender charges will be applied.

Many executives also participate in **nonqualified deferred compensation plans**. Because a nonqualified plan is not subject to ERISA rules, a QDRO is not used to set aside benefits for the former spouse. A division of the assets of the nonqualified deferred compensation plan will not shift the tax liability to the former spouse.

Stock options also pose challenges in property division. The date chosen for determining asset value is crucial. Value can differ widely, depending upon whether it is based on the date of the initial separation, the date on which the divorce was finalized, or the date of option vesting.

Consult a professional

Because valuing and dividing a couple's assets is complex, consider bringing in a third-party professional such as your financial planner or a Certified Divorce Financial Analyst (CDFA). Experienced with valuing retirement plans and employee benefits, a CDFA professional can act as an advisor to your attorney or as a mediator for you and your former spouse to help in pursuing an equitable settlement.

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