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Divorcing Individuals can have Penalty Free Cash

Many couples caught in the trauma of the divorce process face the same problem. One or both may have significant retirement accounts with their employer, but believe that these funds are not available to them without the IRS 10% penalty tax. Most times, it is not good reasoning to liquidate all or part of your retirement funds for purposes other than retirement; however, this may be the only source of cash available to maintain your standard of living.

Under a special section of the Internal Revenue Code (72(t)(2)(C), an *alternative payee* can take cash from a Qualified Plan (such as a 401k), **without the 10% penalty**, even if they are under age 59 ½. To avoid the penalty, the following criteria must be met:

1. The retirement plan must be a qualified plan covered by ERISA (e.g. 401K and Defined Contribution Plans);

2. The funds must be paid to an alternative payee, not the owner of the account; and

3. A Qualified Domestic Relations Order (QDRO) must be created and used to divide the plan

The amount paid is taxable income to the to the alternate payee and the employer will withhold 20% of the distribution to repay the tax. So if the spouse has a need for less than the entire account balance, the 20% withholding should be taken into account when asking for a withdrawal. Alternatively, if the spouse who is entitled to the distribution does not need all of the cash, part could be paid in cash and part could be *transferred* to that spouse's IRA. Again, there will not be a 10% early distribution penalty.

What if both spouses needed cash?

This could be a difficult and risky maneuver; however, the non-employee spouse could take more cash than needed and give the excess cash to the employee spouse. This type of arrangement would have to be protected by a legal document.

Lets look at an example.

Tom and Nicole, age 45, are getting divorced. As part of the settlement agreement, Nicole is entitled to 50% of Tom's 401K containing $400,000. Nicole needs cash of $100,000 to establish an emergency fund and pay some outstanding bills. Their attorney creates a QDRO that orders Tom's employer to assign funds totaling $200,000 to Nicole.

Nicole could ask Tom's employer for $125,000 in cash, with $25,000 withheld to prepay the Federal income tax. Nicole could also ask that the employer transfer $75,000 to her IRA. In this transaction, Nicole would receive $100,000 in cash (and taxable income of $125,000) and $75,000 in her IRA, which is nontaxable. There would not be an IRS penalty for this withdrawal and transfer. It is very important to understand the type of retirement plan that is involved in this situation, as the QDRO will not be effective unless its assignment of rights, or division of pension benefits complies with the terms of the plan.

One word of caution, this rule does not apply to IRAs. Any premature distribution related to a divorce would be subject to a 10% premature penalty.